

## CHAPTER 4

### Framework for Resolution of Financial Institutions

*The Key Attributes of Effective Resolution Regime for Financial Institutions laid down by the Financial Stability Board (FSB) define the scope of resolution regime to include any financial institution whose failure could be systemically significant. Each jurisdiction is expected to have a designated administrative authority responsible for leading and exercising resolution powers, with the objective of pursuing financial stability, ensuring continuity of critical services of systemically important financial institutions, protecting depositors, insurance policyholders and investors, while avoiding destruction of franchise value of the institution and adopting speedy, predictable and least cost resolution method. Some of the authority's key powers should include the ability to override the rights of shareholders, replace management, operate a bridge institution and enforce losses on senior unsecured creditors (bail-in), where warranted. Recognizing the need for advanced planning, the FSB emphasizes the importance of appropriate recovery and resolution plans for systemically important financial institutions (SIFIs), whose feasibility and credibility would be regularly assessed by the regulatory authorities. Authorities should have arrangements to meet the need for resolution funding without relying on public ownership or bailouts. Temporary public ownership could, however, be used as an emergency tool only when considered absolutely necessary to maintain financial stability and when all other resolution options do not appear feasible. Key Attributes also encourage domestic authorities to achieve a cooperative solution with foreign authorities in resolving a cross-border financial institution. India, along with other FSB member jurisdictions, is committed to implementing the Key Attributes by end-2015.*

**4.1** Since the onset of the global financial crisis that involved failure and collapse of some large and complex financial institutions leading to unprecedented range of measures taken by the authorities to avoid disorderly bankruptcies that could have severely undermined

financial stability, there has been widespread emphasis on ensuring that every jurisdiction has an effective financial safety net including a robust resolution framework and crisis management framework in place. This is especially important in jurisdictions that are home to sophisticated, complex and systemically important financial institutions.

**4.2** Emerging practices suggest that a number of key features should be included in the financial safety net and crisis management framework, such as sound institutional arrangements with effective regulation and supervision, supervisory mechanism for early intervention in a problem financial institution to prevent its failure, a robust resolution framework should it still fail, a well-designed guarantee scheme for depositors, and explicit inter-agency coordination and information sharing mechanism and legal basis for exchange of confidential information before and in times of distress. It is also recognized that financial support by the government may be provided only in extraordinary situations to avoid any systemic crisis and for maintaining financial stability.

**4.3** As mentioned in Chapter 2, the Financial Stability Board, in October 2011, published Key Attributes of Effective Resolution Regime for Financial Institutions setting out comprehensive principles on the resolution of SIFIs and other financial institutions. These Key Attributes serve as international standards and call for an effective “resolution regime” to be put in place in all jurisdictions that provides the resolution authority with a broad range of powers and tools supported by adequate funding arrangements to resolve a firm that is no longer viable and has no reasonable prospect of becoming so. The basic objectives are to (i) make feasible the resolution of financial institutions in an orderly manner without severe systemic disruption, (ii) maintain continuity of vital economic functions of non-viable institutions, (iii) impose losses on the shareholders and uninsured and unsecured creditors, and (iv) avoid exposing taxpayers to loss.

**4.4** The Key Attributes are not applicable for all sectors of the financial system and in all circumstances. In order to facilitate and support the implementation of Key Attributes across jurisdictions, the FSB is in the process of developing guidance and providing policy directions on various aspects for banks, insurance companies, other non-bank financial institutions and financial market infrastructures (FMIs) (as detailed in Chapter 2). While framing the recommendations, this Group has taken into consideration the documents released so far as well as consultation documents published by the FSB. The Group has also been guided by the advancements made by a number of jurisdictions, especially advanced countries, in refining and developing their resolution frameworks to prepare

themselves to handle crises of dimensions such as the one that occurred in 2007/2008 in a less disruptive manner.

## **Preparedness for Dealing with Failures**

**4.5** India has a history of very few major bank failures and even fewer failures of insurance companies, securities firms, or FMIs. Although the global financial crisis did not have a direct impact on Indian financial institutions, the economy experienced stress on account of increased integration with global economy through trade, finance and confidence channels. The impact on the economy on account of a combination of international and domestic factors affected the financial institutions, which is being reflected in increased non-performing and restructured assets, low net interest margin, and reduced returns on equity. Though there were no failures, there were some early signs of problems in other parts of financial system, especially the mutual funds and the NBFCs. Major disruptions, however, were avoided through a well-coordinated response by the government and regulators that helped maintain financial stability. However, the stress did not reach a stage requiring resolution of any financial institution or FMI and hence these responses did not involve use of taxpayers' money or any government guarantees in any manner.

**4.6** While major bank failures have not happened, there have been instances of failures in the co-operative banks owing to their weaker financial conditions partly stemming from governance issues. While the co-operative banks are too small to have a major impact on financial stability, there have been instances in the past when failure of a co-operative bank, viz., Madhavpura Mercantile Co-operative Bank affected the entire cooperative banking sector and public confidence in them.

**4.7** 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.

**4.8** The Indian financial system is dominated by banks, which account for 63 per cent of the total financial assets, followed by insurance companies with 19 per cent, non-banking financial institutions with 8 per cent, mutual funds with 6 per cent each and provident and pension funds with 4 per cent. Thus, any discussion of SIFIs in India will largely tend to focus on banks as they are the major likely originator of system-wide risk.

**4.9** Historically, even internationally, banks have generally been at the centre of the crisis. Banking crises are a common phenomenon in advanced economies. Such crises can result in large costs to any economy, affect other banks in the system, and undermine the stability and health of the financial system in general through contagion. The cost involved in bank failures could be varied and there could be large fiscal expenditures depending upon factors such as deposit losses and loss of trust in the financial system, etc. which in turn could affect current as well as potential growth.

**4.10** Although effective regulation and supervision – a component of safety net framework - increases the resiliency of the financial system, it does not eliminate the possibility of failure. There are limits to what regulation and supervision can achieve in averting the failure of a financial institution and occurrence of a financial crisis. A study by IMF (2009c) shows that banks that were intervened in the current crisis often showed higher capital adequacy ratios before the crisis than the non-intervened banks, illustrating the inadequacies in risk measurement and thereby in identification of failing institutions partly because of data gaps. It is thus clear that prudential regulation alone cannot immune the financial institutions from the risk of failure. This has been evidenced not only in the recent global financial crisis but also in the past history that failures are bound to happen.

**4.11** There needs to be a mechanism in place which allows failure of weak financial institutions, but limits the impact on the economy and protects essential and vital economic functions. Simultaneously, it is equally important to instil confidence in the minds of the general public that if a crisis in a regulated financial institution were to occur, the respective regulators and supervisors, and the resolution authority have the powers needed to deal with the situation in a manner that preserves financial stability and limits, to the extent possible, the use of taxpayers' money.

**4.12** *The Financial Sector Legislative Reforms Commission (FSLRC) is also of the view that elimination of all failures of financial institutions is neither feasible nor desirable, and that weak firms should fail and in the process free up labour and capital, which would then be utilized by better firms. Failure of firms is an integral part of the regenerative process of the market economies.*

**4.13** As stated in Chapter 3, there are gaps in the financial safety net framework in India and the existing provisions for resolution of financial institutions under various laws do not provide adequate powers to the authorities. **Thus, while there are existing regulatory**

provisions to deal with failing financial institutions, with a view to further strengthening the existing financial safety net framework and bridging the gaps in the resolution framework vis-à-vis the Key Attributes, the Working Group recommends that there should be a policy framework supported by law to deal with the failure of financial institutions<sup>1</sup> and financial market infrastructures<sup>2</sup> that are nearing non-viability in a manner that avoids disruption to the supply of critical financial services. *(Recommendation 1)*

## Need for Resolution Framework for Financial Institutions

### *Financial institutions are special*

**4.14** The financial system, especially banks, play a crucial role in the economy and perform critical functions (e.g. provision of credit, deposit taking, and operation of payment systems) that are necessary and essential for economic activity to take place. Banks also play an essential role in the transmission of monetary policy. Financial institutions provide a range of services, including, for example, facilitating trading in securities, providing insurance in various areas, infrastructure like functions as custodial, clearing, settlement and payment-processing services etc., which, if interrupted, have the potential to affect the real economy adversely.

**4.15** An important characteristic of the financial sector is that it is based on continued public confidence in the soundness and safety of its institutions. That confidence can be easily undermined, which may lead to runs, contagion and wider systemic consequences. Insolvency of a bank, particularly one with a large number of depositors and financial counterparties, has the potential to generate wider costs or ‘negative externalities’ for society extending well beyond the losses to a bank’s immediate creditors. Unless checked in time, the loss of confidence in one or a few banks may spread through contagion to many otherwise sound banks, affecting financial stability across financial system as a whole.

**4.16** The special characteristics of banks make them different from other institutions and firms. Banks are special and the normal corporate insolvency frameworks do not work in the

---

<sup>1</sup> 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), non-banking financial companies, insurance companies, securities firms, commodities markets and pension schemes.

<sup>2</sup> The term “financial market infrastructures” refers to payment systems, central counterparties (CCPs) including clearing houses, securities settlement systems (SSSs), central securities depositories (CSDs), and trade repositories (TRs), etc.

case of banks because (i) banks have to be resolved quickly, (ii) the objectives of bank resolution is protection of depositors (while corporate insolvency is about protecting creditors, owners and keeping the firms functioning), and (iii) interconnectedness of banks makes resolution a specialised task.

**4.17** Other types of institutions in the financial system can also pose a risk to financial stability. The disorderly failure of FMIs could severely disrupt financial markets as they facilitate the clearing, settlement and recording of monetary and other financial transactions, such as payments, securities and derivative contracts. These are critical financial services, the disruption of which can have significant implications for the stability of the financial system.

**4.18** The FMIs are subject to a number of risks – legal, credit, liquidity, general business, custody, investment and operational risks – that could threaten the viability and financial strength of an FMI. For some FMIs like, central counterparties (CCPs), significant credit losses or liquidity shortfalls may arise from default of one or more market participants and lead to probable failure of the FMI. For FMIs that hold or invest cash or collateral posted by participants, the failure of a custodian bank or poorly performing investments<sup>1</sup> could create losses for the FMI. General business risk<sup>2</sup>, including the operational and legal risks, could also lead to unanticipated losses. These risks have the potential to result in an FMI’s failure, particularly if proper risk management processes are not in place ex-ante. If not properly managed, the FMIs can be sources of financial shocks and these shocks can be transmitted across domestic and international financial markets.

**4.19** Though there is less probability of an FMI reaching a point where it needs to be resolved, nevertheless the possibility of it reaching that stage cannot be ruled out. Moreover, occurrence of problems in any of the financial institutions will necessarily affect the FMIs wherein the particular problem financial institution is a member. Systemically important FMIs<sup>3</sup> play an essential role in the global financial systems and the disorderly failure of such

---

<sup>1</sup> Investment risk is the risk of loss faced by an FMI when it invests its own or its participants’ resources, such as cash or other collateral. Similarly, custody risk is a risk of loss on assets held in custody in the event of a custodian’s insolvency, negligence, fraud, poor administration or inadequate record-keeping.

<sup>2</sup> General business risk refers to the risks and potential losses arising from FMI’s operations as business enterprise that is not related to participants’ default or to custody and investment risks.

<sup>3</sup> The CPSS-IOSCO document on “Principles for Financial Market Infrastructure”, published in April 2012, considers a payment system to be systemically important if it has the potential to trigger or transmit systemic disruptions; this includes, among other things, systems that are the sole payment system in a country or the principal system in terms of the aggregate value of payments; systems that mainly handle time-critical, high-

FMI could lead to severe systemic disruption if it caused markets to cease to operate effectively. Ensuring that FMIs can continue to provide critical services, even in times of extreme stress, is therefore central to financial stability.

**4.20** The insurance sector – general and life insurance – provides vital services needed for the management of risk. Insurance also provides an important source of funds for investment in various sectors of economy through receipt and investing of insurance premiums. The traditional insurance business model is different from banking. Insurance underwriting risks are not correlated with the economic business cycle and financial market risks. The nature of traditional insurance liabilities, where payment to policyholders arise only on occurrence of an insured event, is less likely to suffer sudden cash runs that would drain liquidity. Though traditional insurers do not generally threaten the stability of the financial system in the same way as the deposit-takers and the FMIs, the insurance groups/conglomerates engaged in non-traditional and non-insurance (NTNI) activities can be vulnerable to financial market developments and may contribute to systemic risk. Nonetheless, the failure of even traditional insurers that are large in size have the potential to affect the real economy adversely.

**4.21** The International Association of Insurance Supervisors (IAIS) have, in their November 2011 report on ‘Insurance and Financial Stability’, concluded that insurers engaged in traditional insurance activities, though impacted by the financial crisis, were largely not a concern from a systemic risk perspective. However, insurance groups and conglomerates that engage in non-traditional or non-insurance activities are more vulnerable to financial market developments and are more likely to contribute or amplify the systemic risk.

**4.22** Along with banks, FMIs and insurance sectors, other categories of financial institutions like pension funds also contribute significantly to economic growth and development by mobilising savings and providing a social safety net for the elderly. The source of funds of pension system includes compulsory superannuation contributions for the employees and voluntary contributions in pension schemes offered by private pension providers. The failure of pension funds and other saving vehicles can result in wiping out of savings and affect public and market confidence.

---

value payments; and systems that settle payments used to effect settlement in other systemically important FMIs. The presumption is that all CSDs, SSSs, CCPs, and TRs are systemically important, at least in the jurisdiction where they are located, typically because of their critical roles in the markets they serve.

**4.23** With the liberalisation in the financial sector, the Indian financial landscape has seen the emergence of financial conglomerates, i.e., financial services groups comprising a number of legal entities each operating in a different segment of the financial services sector. Currently, the operating financial services entities are the parent entities or holding companies, though in some cases, industrial companies are the parent entities of the financial groups. There may, however, be a move towards a Non-Operating Holding Company (NOHC) structure as recommended in the report of Working Group on Introduction of Financial Holding Company Structure in India (Chairperson: Shyamala Gopinath) and the recent discussion paper on Banking Structure released by RBI in August 2013. A similar structure has been adopted for the New Bank Licensing Process. Thus, the NOHCs may emerge as playing an important role in the financial system and may pose threat to the financial stability and resolution challenges.

#### *Public support and moral hazard*

**4.24** The lack of a credible resolution framework poses a ‘moral hazard’ problem especially among SIFIs by creating expectation among their management, shareholders and creditors that the institution will not be allowed to fail and they will not have to bear the cost of risks that they take. The implicit government guarantee generates a funding subsidy for financial institutions that are considered too big or important to fail. In turn, this lowers incentives for market discipline and encourages risky behavior.

**4.25** Effective resolution framework must ensure protection of critical stakeholders and functions, such as depositors, insurance policy holders, investors and payment systems, while other parts that are not key to financial stability, may be allowed to fail. In order to avoid moral hazard and use of taxpayers’ money, shareholder and unsecured debt holders need to know that they will bear an appropriate share of the losses in the event of a failure and attribute a suitable price to this risk.

**4.26** The Working Group recognised that the consensus amongst policy makers globally is that any effective resolution framework must be able to prevent the systemic damage caused by a disorderly collapse while limiting the exposure of the taxpayer to the risk of loss. In order to achieve this, the resolution authority in India must be able to intervene quickly to ensure the continued performance of the firm’s essential financial and economic functions, including uninterrupted protection of insured depositors, insurance policy holders and investors, and to transfer and sell viable portions of the firm while apportioning losses among



the unsecured creditors in a manner that is fair and predictable and thus avoid panic in the financial markets.

**4.27** *The FSLRC has also recommended that in order to avoid disruptive failure of the financial institutions, a specialised 'resolution mechanism' should be established for dealing with the possible failures of financial firms and its consequences on the Indian economy.*

**4.28** Due to separate statutes governing various types of financial institutions in India, the Group recognizes the difficulties in bringing all financial institutions within the scope of a single financial resolution framework without a separate legal framework that overrides all other relevant Acts. **Considering the special nature of financial institutions, as well as limitations in applying corporate insolvency laws to these institutions, the Group recommends that there should be a separate comprehensive legal framework for resolving financial institutions and FMs. (Recommendation 2)**

## **Objectives of Resolution Framework**

**4.29** The use of the term 'resolution' is considerably broad in the international context. The IMF defines resolution as the "full range of recovery and resolution activities that involve public intervention (either privately or publicly funded) including, for example, mergers and acquisitions, equity recapitalisation, debt for equity conversions, transfer of assets and liabilities, temporary administration, reorganisation, and liquidation". The Cross-Border Bank Resolution Group (CBRG) of Basel Committee on Banking Supervision (BCBS) has defined resolution as "any action by a national authority, with or without private sector involvement, intended to maintain financial stability and/or address serious problems in a financial institution that imperil its viability (e.g. a substantive condition of authorization) where, absent resolution, the institution is no longer viable and there is no reasonable prospect of it becoming so". The FSB defines resolution as "any action taken by a public authority in respect of a firm that meets the conditions for entry into resolution, including in particular the exercise of a resolution power specified in Key Attribute 3, with or without private sector involvement, with the aim of achieving one or more of the statutory objectives of resolution. Resolution may include the application of procedures under insolvency law to parts of a firm in resolution, in conjunction with the exercise of resolution powers".

**4.30** In order to function effectively, it is recognized that the resolution framework must achieve certain economic objectives:

- (i) The foremost objective of any resolution framework is to safeguard financial stability.
- (ii) The confidence of general public is of particular significance in maintaining stability in financial system. Public confidence can be enhanced by insurance systems to protect the interest of the depositors, insurance policyholders and investors within credible limits, normal financial services will continue to be made available, and contagion effect of problem in one institution will be avoided.
- (iii) An effective resolution framework should ensure that the losses are absorbed by the firms' owners (shareholders) and the uninsured and unsecured creditors, and still if not sufficient, by the wider financial system.
- (iv) As with any insolvency proceedings, resolution of financial institutions should achieve both *ex-post* and *ex-ante* efficient outcomes. While *ex-ante* efficiency necessitates penalizing managements and shareholders of financial institutions, the *ex-post* efficiency requires that the administrator/liquidator maximises the total value of the creditors through various resolution tools and options, in other words adopt resolution tool with least cost to the financial system.
- (v) Time and speed are of particular importance in resolving financial institutions, especially banks, as compared to resolving companies in general. This is because even solvent banks can face illiquidity if they experience a run due to real or perceived problems affecting the bank. If resolution is initiated too late, or moves too slowly, it could increase potential losses and heighten the risk of contagion to other financial institutions.
- (vi) The resolution action must respect hierarchy of claims and have transparency about the manner in which losses would be absorbed by the shareholders and other general creditors. Equity should absorb losses first, and no loss should be imposed on senior debt holders until subordinated debt (including all regulatory capital instruments) has been written-off entirely.

**4.31** *The FSLRC has recommended certain objectives that will guide the resolution framework for failed (or approaching the point of failure) covered service providers<sup>1</sup>. These include – (a) to protect and enhance the stability and resilience of the financial system; (b) to enhance financial market efficiency through the efficient pricing and allocation of risk; (c) to*

---

<sup>1</sup> The FSLRC defines 'covered service providers' as those financial service providers that make covered obligations and also those that are designated as SIFI by the FSDC, that are eligible for obtaining insurance from Unified Resolution Corporation.

*protect consumers of covered obligations up to a reasonable limit; and (d) to protect public funds.*

**4.32** While the broad objectives for an effective resolution framework have been indicated above, it needs to be reemphasised that the aim of resolution is not to preserve the failing institution, but to ensure the continuity of the functions that are critical for the financial system as a whole and limit any use of taxpayers' money. The Group recommends that the resolution framework in India should be guided by the following objectives:

- initiate resolution action in a timely and speedy manner;
  - avoid erosion of value and minimise the costs of resolution;
  - protect and maintain stability of the financial system as well as public confidence in Indian financial system;
  - ensure continuity of essential financial services and critical functions such as payment, clearing and settlement functions;
  - protect depositors, insurance policyholders, and client funds/assets, through protection schemes and other arrangements, within reasonable limits;
  - avoid use of taxpayers' money and not create an expectation that public support will be made available, thus ensuring market discipline;
  - ensure imposition of losses to shareholders and unsecured creditors in a manner that respects hierarchy of claims; and
  - ensure predictability through clear legal framework and procedural clarity.
- (Recommendation 3)*

## **Scope of Financial Resolution Framework**

**4.33** Introduction of financial resolution framework requires careful reflection of the scope of the framework. Different jurisdictions, traditionally, have included very different institutions in their resolution frameworks. Following the global crisis, however, an international consensus has emerged, suggesting that the resolution framework must be broad based and cover all significant financial institutions. Specifically:

- The Special Resolution Regime (SRR) of United Kingdom extends to only UK-incorporated banks (deposit-taking institutions including building societies), UK subsidiaries of foreign banks, and the branches of UK-incorporated banks outside the United Kingdom. The UK Government has set out proposals for broadening its

authority to include systemically important non-banks, i.e. investment firms and parent undertakings, central counterparties, non-CCP financial market infrastructures, and insurers.

- The United States enhanced its resolution framework through enactment of Dodd-Frank Act, 2010. The framework distinguishes systemic and non-systemic institutions. Non-systemic institutions are resolved as per their respective statutes/laws, while systemic firms (including systemic securities firms, insurance firms and FMIs) are resolved in terms of provisions of Dodd-Frank Act.
- The Consultation Paper issued by European Commission in October 2010 and June 2012, proposes a resolution framework for all systemically important credit institutions and investment firms. The Commission is working on expanding the scope of the resolution framework to other financial institutions, including insurance companies, investment funds and central counterparties.

**4.34** All financial institutions need to be included in a resolution framework. Since banks play the most unique role in any economy, it is clear that they need to be covered within the scope of the resolution framework. The functions carried out by the FMIs, either the CCPs or payment systems, securities settlement systems, stock exchanges, etc., clearly indicate that they also have an obvious potential to become systemic and could result in severe disruption to financial markets and on wider economic activity. The FSB's consultative document on "Application of Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions" has *inter alia* suggested that all FMIs that are systemically important, other than FMIs owned and operated by central banks, should, in the event of failure, be subject to a resolution regime. Finally, the failure of insurer may not trigger financial instability but has the potential to stall the effective functioning of financial markets and economic activity.

**4.35** Over a period, the operations of non-bank financial companies (NBFCs) have grown rapidly, becoming one of the important elements of India's financial system. With tightening of the prudential regulatory norms for deposit taking companies, the NBFCs remain relatively less regulated. Moreover, they are expanding their operations through borrowings, especially from banks. This development further highlights the interconnectedness within the financial system. The excessive inter-institutional exposure could make the financial system vulnerable.

**4.36** The failure of Madhavpura Mercantile Co-operative Bank (MMCB) and the extent of interconnectedness of various urban co-operative banks with MNCB indicates the importance of co-operative banks in the financial system. Though the co-operative banks constitute only 6 per cent of the total financial assets and their failure may not trigger major disruption in the financial system, the incidence of failures among co-operative banks is high and hence important from the angle of depositor protection.

**4.37** The present European crisis has shown that even a large number of small banks can be deemed as systemic and could create systemic risk, e.g. Cajas or savings banks in Spain and Landesbanken in Germany (Box 4.1).

#### **BOX 4.1**

##### **Small banks could be systemic**

###### **Cajas of Spain**

In Spain, Cajas are financial institutions which specialize in accepting savings deposits and granting loans. Their original aim was to create the habit of thrift amongst the very poor but they have evolved to compete with and rival commercial banks.

During the boom period, between 1999 to 2007, the Spanish economy grew at the rate of 3.7 per cent and the property prices during the period 2004-2008 grew by 44 per cent. Since the advent of recent crisis, the property prices fell by 25 per cent leaving banks with huge stressed assets. Before the credit crunch, the banks had been thriving due to the rapid expansion of the property sector. But its collapse resulted in default from borrowers who were severely impacted by the plunge in the value of the assets on which the loans were based on.

To cater to the problem many of Spain's smaller, weaker banks have had to merge or were rescued by larger ones. Up to the end of April, the government had injected €34bn into its banks, according to the IMF. That is exclusive of the €19bn, Bankia, Spain's fourth-largest bank, asked for shortly before it was nationalised. Bankia itself was formed when several regional banks, or Cajas, were brought together because they were too small to bear the knock from the economic downturn. Now these smaller banks, which were individually systemically not important, post-merger have become systemically important and the Spanish government is forced to bail-out these banks.

###### **Landesbanken of Germany**

The Savings Bank Finance Group of Germany comprises approximately 660 member institutions – including 463 Sparkassen (savings banks), 11 Landesbanken, 11 Landesbausparkassen, and 12 public insurance companies and a number of asset management, leasing, and factoring companies – with combined total assets of Euro 3.2 trillion.

Within the Savings Bank Finance Group, the Landesbanken act as centres for payment systems and liquidity providers for the savings banks in their regions (states). They also serve as a link between the savings banks and their customers when it would be less efficient or economically impossible for the savings banks to keep certain products in store for a small number of customers. Examples of this would be private banking services, capital markets products, international trade financing capabilities, or instances in which customers pose too much of a concentration risk for the savings bank, especially in the lending business.

The Landesbanken are state owned banks and system is unique to Germany. Landesbanken are owned by their respective states and regional savings banks (represented by the regional associations of savings banks). They are regionally organized and their business is predominantly wholesale banking. They are also the head banking institution of the local and regional bases

*Sparkassen* (or the saving banks) of Germany.

As commercial banks in their own right, Landesbanken serve medium- to large-sized corporates in their regions, as well as multinationals via their own branches and representative offices abroad and their large network of correspondent banks. Some Landesbanken also command retail banking networks, while others have developed niches in corporate finance (e.g. financing ship or aircraft projects). The majority of Landesbanken also service the financing needs of the public sector, not as development banks but more as lenders for large commercially driven projects, such as infrastructure projects.

During the global financial crisis of 2008, a number of landesbanken institutions landed in crisis and applied for funds and loan guarantees from the German bail-out fund. It has been criticized that the government needed to deregulate the industry and allow stronger banks to take over weaker players, particularly among the publicly-owned landesbanken.

**4.38** *The FSLRC has suggested coverage of all covered service providers within the scope of the resolution regime so as to avoid creating any perception of safety in the minds of consumers or an expectation that certain specific financial institutions (such as public sector banks) will be insulated from the failure. In order to make co-operative banks, governed by state legislations, also fall within the scope of resolution regime, the Commission has recommended that the co-operative societies carrying on financial services should be subject to similar regulatory and supervisory framework as other entities carrying on similar activities. For this to happen, the State Governments should accept, using Article 252 of the Constitution of India, the authority of the Parliament to legislate on matters relating to resolution of failed co-operative banks.*

**4.39** **The scope of the financial resolution framework in India should cover all financial institutions – including commercial banks (public sector banks, private sector banks, and foreign banks having branch/subsidiaries in India), co-operative banks, regional rural banks; non-banking financial companies, firms/companies in insurance, pension, securities and commodities markets; and FMs including payment systems, securities settlement systems, central counterparties, securities depositories, etc. other than those owned and operated by the Reserve Bank of India, viz. real time gross settlement system and securities settlement systems. The proposed legislative framework for resolution should enable the resolution authority in coordination with the respective regulator to designate any other financial institution that will be covered by the framework. (*Recommendation 4*)**

*Scope of resolution framework to cover parent undertaking or the holding company*

**4.40** The recent global financial crisis has shown that the complexity of the operational structures that most national/international financial conglomerates have developed is itself a significant source of systemic risk. Failures of such institutions can cause widespread

damage to financial sector and have a drastic contagion effect in an economy. Typically, these legal entities would be subject to scores of different regulatory and supervisory mechanisms, many of which may conflict or overlap. This was clearly evident in the case of Lehman Brothers, wherein a trade performed in one company could be booked in another and the lines of business did not necessarily map to the legal entity lines of the companies.

**4.41** The holding company acts as a source of strength and support to the subsidiaries and affiliates attached to it. However, in case of market-wide stress or due to the contagion effect of financial distress in its subsidiaries or affiliates, the holding company could itself come under stress. There may, therefore, be a need to extend the resolution framework to cover the holding company also.

**4.42** The Group recommends that the scope of the proposed financial resolution framework should also cover the parent undertaking or the holding company regulated by the financial sector regulator, of the financial groups. (*Recommendation 5*)

## Constitution of Resolution Authority and its Role

**4.43** The financial sector institutional framework of India primarily comprises five agencies with clear mandates and distinct allocation of powers. The Reserve Bank of India (RBI) performs traditional central bank functions, including conducting monetary policy, regulation and supervision of the deposit-taking institutions<sup>1</sup> (commercial banks, co-operative banks, and regional rural banks), NBFCs, development financial institutions (DFIs), primary dealers, and payment systems, and regulation of financial markets. The RBI also acts as the lender of last resort and has an implicit mandate to preserve financial stability. The Insurance Regulatory and Development Authority (IRDA) is the prudential regulator and supervisor for companies providing insurance services and products. The Securities and Exchange Board of India (SEBI) regulates the securities market as well as the stock exchanges and the clearing corporations that provide trading or clearing or settlement facilities in respect of securities. The Pension Fund Regulatory and Development Authority (PFRDA) regulates pension funds and the Forward Markets Commission (FMC) regulates the commodity futures market in India.

---

<sup>1</sup>Supervision of state co-operative banks, district central co-operative banks and regional rural banks is carried out by the National Bank for Agriculture and Rural Development (NABARD).

**4.44** Currently, different types of banks and financial institutions are resolved by separate sectoral authorities (the regulators) as per their respective laws. These regulators have only limited powers<sup>1</sup>. They are responsible for identifying failed institutions and either finding merger partners or withdrawing the operating license and requesting the courts to appoint a liquidator for eventual liquidation. Regulators have few tools for restructuring the institution into a solvent, viable institution. Presently, any bank or insurer that is facing problem of insolvency in India is either made to merge or amalgamate (voluntarily or compulsorily) with a stronger institution, or is liquidated. The Government of India has the authority to use public funds in support of resolution and crisis management of all financial institutions. The Government may take institutions into temporary public ownership.

**4.45** India has only limited experience in resolving failed institutions. During the past decade, while nine commercial banks<sup>2</sup> were voluntarily amalgamated, there were five cases<sup>3</sup> of compulsory amalgamation. However, there have been no cases of liquidation of commercial banks during the last two decades, except for Bank of Karad in 1992, a part of which was later sold to another bank (Bank of India).

**4.46** A critical lesson from the global crisis is that financial stability is strengthened when failed institutions can be restructured and performing assets and critical financial services remain in the financial system. A resolution authority should have the capacity to intervene a failing institution, identify performing assets and critical functions, and then adopt a resolution strategy that has least cost.

**4.47** The FSB Key Attributes provide an effective framework for developing appropriate resolution tools. The Key Attributes stress the importance of time and speed in resolving a financial institution. Given the complexity of resolution functions, the Key Attributes argue

---

<sup>1</sup> The existing powers of various financial sector regulators in respect of conducting resolution of problem financial institutions have been detailed in Chapter 3.

<sup>2</sup> (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.

<sup>3</sup> (i) Benares State Bank Ltd. (BSBL) amalgamated with Bank of Baroda on June 19, 2002; (ii) Nedungadi Bank Ltd. amalgamated with PNB on February 1, 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.



that a specialised institution is needed to carry out the resolution activities. Such an institution will need to have the ability to analyze resolution options quickly, have adequate tools for implementing the resolution and be able to engage in intensive coordination, cooperation and information sharing between the authorities at each stage of the decision-making process. These characteristics would enable prompt and coordinated resolution action to be taken, specifically where a variety of financial entities are involved in a financial group/conglomerate as well as in case of cross-border financial institutions.

**4.48** The Group acknowledged that the financial regulators have the expertise, resources and the operational capacity and the know-how of the respective financial institutions they regulate and supervise. However, taking into account the emphasis laid in the Key Attributes on a specialized resolution authority, the Group agreed on balance that since resolution requires very specific techniques and specialization which regulators/supervisors are unlikely to possess besides the fact that there are moral hazard issues involved in regulators/supervisors handling resolution, the resolution agency should be separate from the regulatory/supervisory authorities and be independent. Establishment of a resolution agency raises a number of issues. First, creation of a separate resolution authority would require extensive set-up with the associated legal framework and institutional infrastructure for proper functioning. Second, a decision will need to be made on whether a single resolution authority is required to be established, with responsibility for all financial institutions, or whether sector-specific resolution agencies are needed. Third, the resolution authority will need tools that are appropriate both for small and medium sized institutions as well as tools for the SIFIs.

**4.49** There are a number of advantages of a single resolution authority for all categories of financial institutions. Resolution being a specialized function, setting up resolution authority separately from regulators and supervisors would enable development of the expertise needed for such a function to be performed effectively. Having a separate resolution authority for all sectors would also enable it to handle financial conglomerates more effectively. Further, with the funds for resolution maintained in a single entity, use of funds across sectors will be feasible and would reduce the likelihood of relying on government support. The Group recognises that the resolution authority will not require a very large establishment as respective regulators/supervisors provide will provide the first line of defense in the safety net framework.

**4.50** *The FSLRC has recommended setting up of a Unified Resolution Corporation that will deal with an array of financial firms such as banks, insurance companies, defined benefit pension funds, and financial market infrastructure such as payment, settlement and clearing systems. The FSLRC has recommended establishment of a resolution corporation as a statutory body to carry out the resolution of all covered service providers. It also specifies that the resolution corporation must have representation from across the financial regulatory architecture, including the central bank, financial regulators, the Central Government, and independent experts. Since the setting up of an independent Resolution Corporation will require a statutory framework for its implementation, the Financial Stability and Development Committee (FSDC), in its meeting held on October 24, 2013, has decided to set up Task Force to lay the roadmap for the setting up of the Resolution Corporation (RC), Financial Sector Appellate Tribunal (FSAT), Public Debt Management Agency (PDMA) and Financial Data Management Centre (FDMC). The constitution of a Task Force towards creation of a Resolution Corporation has, however, been postponed till this Working Group submits its report.*

**4.51** **The Group considered the pros and cons of having a single resolution authority. The Group recommends that:**

- (i) there should be a single Financial Resolution Authority (FRA) mandated under the law for resolving all financial institutions and FMIs, in coordination/cooperation with the respective financial sector regulators, as deemed necessary by the FRA,**
- (ii) the FRA should be institutionally independent of the regulators/supervisors and the Government,**
- (iii) the FRA should be the sole authority responsible for operation and implementation of the financial resolution framework, including the decision to choose the appropriate resolution tool, except the power to take an institution into temporary public ownership (TPO) that will be invoked by the Government of India on the recommendation of the FRA, and**
- (iv) the FRA should be empowered by the law to coordinate/cooperate with financial sector regulators/supervisors and establish appropriate information sharing arrangements with regulators/supervisors before/during the resolution of a financial institution. (*Recommendation 6*)**

**4.52 The Group also recommends that the mandate of FRA will be to resolve failed financial institutions and FMI (other than those owned and operated by RBI) along with providing deposit insurance and protection to insurance policy holders and investors/clients within limits, if required at the resolution stage. (Recommendation 7)**

**4.53** The Group recognizes that creating a new financial resolution authority will require creation of a separate infrastructure, and inculcating and developing new expertise will be a time consuming affair. The Deposit Insurance and Credit Guarantee Corporation (DICGC), though presently acts just as a pay-box in liquidation of banks, has some kind of experience and expertise in dealing with failures of banks especially payouts to depositors post-failure. As noted in the FSB Peer Review on Deposit Insurance, out of 22 jurisdictions, only seven countries have designed their deposit insurance system as pure ‘paybox’, while the remaining countries have varying degrees of responsibilities in resolution. Some of the countries that have a broad mandate as loss minimizer or risk minimizer<sup>1</sup> are the US, France, Canada, Indonesia, Italy, Japan, Korea, Mexico, Russia, Spain and Turkey. Some countries like UK and Russia have provided additional role in resolution to the deposit insurer after the crisis. Kenya has recently enacted a law to vest resolution powers with the deposit insurance agency.

**4.54 Taking all factors into consideration, the Group recommends that the FRA as a separate entity can be set by either transforming the present DICGC into FRA or by setting up a new authority namely FRA that will subsume DICGC. Either option will require amendment or enactment of laws, institutional changes, staffing, and development of tools and options. (Recommendation 8)**

## Triggers for Entry into Resolution

**4.55** As mentioned in the previous section, the financial sector regulators understand the risk profiles and the strengths of the institutions they oversee. The respective sector regulators are responsible for limiting risks taken by institutions and, when excessive risks build up, they have to take mitigating actions. The regulators are also responsible for identifying when an institution does not turn around in the PCA framework. Once such a

---

<sup>1</sup> A “loss minimiser” mandate is where the insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies, for example in Canada, France, Indonesia, Italy, Japan, Mexico, Russia, Spain, Turkey). A “risk minimiser” mandate is where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities, for example in Korea and United States.

determination is made, the supervisors pass responsibility for resolving the institution to the resolution agency. Simply stated, resolution begins where prompt correction action or early intervention ends. Any resolution action against the problem financial institution should be initiated when it is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution framework needs to specify certain clear standards or thresholds or suitable indicators of non-viability, such that when the threshold is breached or crossed, the resolution authority takes control of the financial institution and commence the resolution process.

**4.56** Such threshold should be such that when the financial position of the institution has weakened substantially, it still has positive net worth. The supervisors would at this stage hand over financial institution to the FRA. Delaying resolution action until the financial institution has reached the point of non-viability is likely to limit the choice of effective options for resolution and would prove expensive.

**4.57** Thresholds for initiating resolution can be either quantitative triggers or qualitative triggers or a combination of both. The resolution triggers vary across jurisdictions and may differ according to the type of financial institution, and the nature of the powers being exercised. Generally, triggers are based on qualitative criteria (i.e., breach of laws, prudential or regulatory thresholds, or supervisory orders). In some countries like the USA<sup>1</sup>, which has a quantitative criterion, the Federal Deposit Insurance Corporation (FDIC), specifies the trigger for resolution as a leverage ratio – tangible equity to total assets – of 2 per cent. The soft thresholds (i.e. qualitative criteria) such as test of “likely to fail” may be difficult to apply. The supervisors in this case would be required to determine that an institution is, or is likely to become financially insolvent or fulfill its licensing conditions.

**4.58** Hard thresholds (quantitative criteria) for resolution would bring transparency to the resolution framework by making it public to all stakeholders the time at which the resolution action would be prompted. Rules also limit forbearance. This would leave little room for disputes and there will not be any scope for divergence in practices by the authorities. However, rules may not capture all considerations that may be indicative of problem in a financial institution. Incorporating soft triggers introduces some degree of judgment and can lead to a near complete appraisal of the situation. Discretion, at times, could be more

---

<sup>1</sup>Section 38 of the FDI Act requires regulators to classify depository institutions into one of the five capital categories based on their level of capital – well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized – and take increasingly severe actions as an institution’s capital deteriorates. Regulators are generally required to close critically undercapitalized institutions within a 90 day period.

appropriate and more suited for a rapid action, such as, when the condition of the financial institution is rapidly deteriorating as a result of loss of access to key funding markets. Such deterioration may not be well captured by the quantitative thresholds.

**4.59** In practice, supervisors use a combination of soft and hard triggers for taking a decision for intervention by the resolution authority. Once intervened, the resolution authority takes responsibility for resolving the institution. Shareholders and uninsured and unsecured debt holders are written down and the resolution authority decides on the resolution option that maintains financial stability and imposes least cost on the economy.

#### ***Early intervention process***

**4.60** Before any resolution action is initiated, there needs to be a framework of early intervention with the regulators/supervisors in order to address problems in the institution at an early stage. Early intervention would involve several measures, i.e., requiring additional capital, improving governance, strengthening systems and internal control framework, increase regulatory reserves, limit business operations and other risk exposures, to avert major insolvency problems due to idiosyncratic or market wide stress events. To ensure the success of the early intervention mechanism, it is important for regulatory/supervisory authorities to have appropriate framework and powers at their disposal.

**4.61** In India, although the financial regulators have a mechanism derived from respective statutes to take some early actions to put the operations of the financial firms in order, there is no clear established framework, (except for commercial banks) for early intervention mechanism and the associated triggers for initiating actions. The FDIC has established a PCA framework of supervisory actions for insured depository institutions that are not adequately capitalized. Many other jurisdictions (Canada, Denmark, etc. to name a few) have introduced and/or are in the process of introducing early warning signals or early supervisory intervention framework to address the problems at an early stage. The early intervention frameworks prescribed by USA, Canada, Denmark and India (RBI) are described in **Annex 4**, which could help other regulators to devise a PCA framework for institutions regulated and supervised by them while also using guidance developed by international standard setting bodies for respective sectors. It will be important that regulators not only put in place a PCA framework but also implement it fully.

**4.62** *With a view to ensuring proactive and timely intervention by the regulators as well as the resolution corporation for orderly resolution of covered service providers, the FSLRC has*

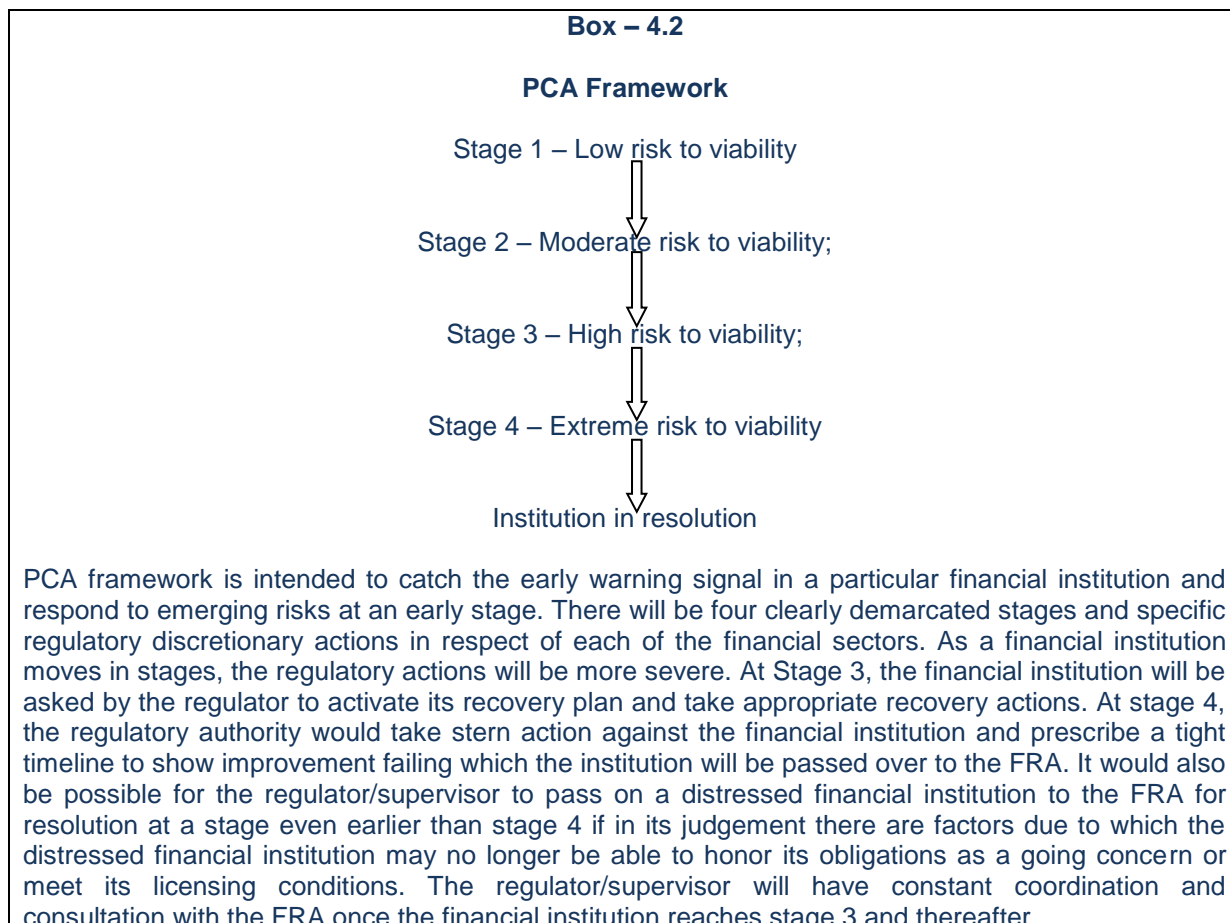
*envisaged a framework of “prompt corrective action” incorporating a series of intervention measures to be undertaken by the micro-prudential regulators and the resolution corporation to restore the financial health of the covered service providers. This would ensure enhanced regulatory intervention and reduced regulatory forbearance by linking regulatory response to a covered service provider’s financial condition. The Commission has prescribed five stages indicating the levels or measures of risk assessment by the regulators – (i) low risk to viability; (ii) moderate risk to viability; (iii) material risk to viability; (iv) imminent risk to viability; and (v) critical risk to viability. The Commission has also recommended that the resolution corporation would undertake a series of activities including the regular monitoring, supervision and evaluation of covered service providers; prompt corrective action; and transferring and disposing assets of failing or failed covered service providers. While, the financial institution upon reaching the first stage (low risk) would be monitored as usual by the resolution corporation, it would be subject to conduct of a special examination by the corporation upon reaching the second stage (moderate risk). In the third stage (material risk), the resolution corporation would require the covered service provider to prepare a resolution plan and will intensify engagement with the covered service provider. Upon reaching the fourth stage (imminent risk), the resolution corporation would apply for receivership of the concerned covered service provider, and in case of the last stage (critical risk) it will cancel or terminate all policies of insurance and apply for liquidation.*

**4.63** Considering that the resolution needs to be initiated when a financial institution is no longer viable or likely to be no longer viable, the Group is of the view that any crisis management framework, formulated to protect the public interest, or the interests of the depositors, insurance policy holders and investors needs to first focus on early intervention by the regulatory/supervisory authorities and corrective actions by the institution. Such mechanism should consist of preparatory and preventive measures, early intervention measures/ tools, etc., so as to identify the developing problems and address the same at an early stage. The early intervention framework will preserve the financial institution’s going concern value to the extent possible by way of intrusive supervisory intervention.

**4.64** In order to ensure that regulators/supervisors can intervene at a sufficiently early stage with clear trigger levels to prevent the institution from reaching situation of non-viability, the Group recommends that each financial sector regulator/supervisor may formulate a prompt corrective action (PCA) framework for the institutions under their regulatory jurisdiction, which may be graded illustratively with four levels – i.e. (i) Stage 1 : low risk to viability; (ii) Stage 2 : moderate risk to

viability; (iii) Stage 3 : high risk to viability; (iv) Stage 4 : extreme risk to viability - in terms of quantitative parameters on a risk-adjusted basis. (*Recommendation 9*)

**4.65** The proposed PCA framework and trigger for resolution is explained in **Box 4.2**.



**4.66** The Group also recommends that when an institution reaches stage 4 (final stage) and is not able to demonstrate or take corrective action within a given tight timeline, then it should be passed on to the FRA. The FRA should be kept informed of all actions and developments relating to the concerned institution once the PCA framework kicks in. Enhanced coordination with the FRA should begin at stage 3 and it would be open to the regulator/supervisor and FRA to take a distressed institution into resolution even at an earlier stage. (*Recommendation 10*)

**4.67** With the new supervisory intervention strategy, i.e., the PCA framework and moreover with implementation of new Basel III capital regulations, with greater focus on common equity capital and on liquidity assessment, there is need for an extensive review of the existing PCA framework prescribed by the RBI. **The Group recommends that with a**

view to detecting problems at an early stage and having suitable redressal and revival mechanisms, the RBI may devise an effective methodology for early intervention and structured actions in line with the recommended stages so as to make it compatible with the envisaged resolution framework while taking into account Basel III framework for commercial banks and other regulatory developments for other entities regulated by RBI. Other sector regulators should also devise a PCA framework and take into account international best practices put forth by respective agencies such as International Association of Insurance Supervisors (IAIS), International Organization of Securities Commissions (IOSCO) and Committee on Payment and Settlement Systems (CPSS), etc. (*Recommendation 11*)

#### *Early intervention for financial group/conglomerates*

**4.68** In India, big financial groups identified as Financial Conglomerates (FCs) on the basis of their significant presence in two or more market segments (banking, insurance, securities, non-banking finance) have come into existence. The Inter Regulatory Forum (IRF) is structured as a college of domestic supervisors by adopting the lead/principal regulator model, with a mandate to carry out two major functions, viz. developing supervisory cooperation for effective consolidated supervision of FCs and assessing the risk to systemic stability due to the activities of the FCs. While steps have been taken towards a more effective consolidated supervision, there is minimal framework for early detection and intervention to address problems occurring at the holding company level and group wide ramification of distress developing in part/s of the group.

**4.69** The Group considered that FCs are of systemic importance. There is a high risk that the distress of one part of the group will quickly affect other parts through various intra-group channels. This is particularly in the case of holding company structure, where a substantial proportion of assets of the holding company of a group comprise its investments in the regulated subsidiaries. A collapse in the value of shares in the regulated subsidiaries could cause the holding company to be in breach of its funding covenants or even itself become insolvent. There may also be cross-defaults and intra-group funding stresses that could cause multiple entity failures across the group. The inability to resolve the group-wide distress as mentioned above could jeopardise financial stability given the wide links with the rest of the economy.

**4.70** The Lehman case illustrates how complexity of group structures can prove to be fatal in a crisis and an aggressive growth strategy by a financial firm to take on greater risk can



undermine financial stability. Although the Secretary of the Treasury, warned shareholders of the need for raising more capital, the Treasury Department did nothing to prepare for such an eventuality to intervene<sup>1</sup>. This shows a clear failure of early regulatory or supervisory actions.

**4.71 So as to detect problems in the parent company including the group-wide ramifications of the stress developing in parts of the group at an early stage, the Group recommends that the Inter-Regulatory Technical Group of FSDC may set up a Group for formulation of a PCA framework in respect of financial groups/conglomerates. This framework should provide for clear and distinct triggers and early intervention actions in line with the stages recommended by this Group taking into account international standards. (Recommendation 12)**

## Resolution Tools

**4.72** In order to achieve the objectives, an effective resolution framework should provide for various options (restructuring options<sup>2</sup> and liquidation options<sup>3</sup>) and tools to the resolution authorities to exercise powers and respond rapidly, flexibly and under conditions of legal certainty to a wide variety of circumstances. While the restructuring options ensure continuity of critical and systemically important functions of the failing financial institution and insulating them from failure, the liquidation options ensure orderly closure and wind-down of the institution's business. In both cases and in case of any resolution tool chosen, losses are always absorbed first by the shareholders and uninsured and unsecured creditors.

**4.73** There are different resolution tools to ensure continuity and to preserve the viability of a financial institution's critical and systemically important functions, the choice of which will depend on the nature of the function. Continuity of critical functions may be achieved through one or a combination of tools/ mechanisms that include the following:

---

<sup>1</sup> Source: Geneva Report on the world economy prepared by International Center for Monetary and Banking Studies (ICMB) and Centre International D'études Monétaires Et Bancaires (CIMB) – A safer World Financial System: Improving the Resolution of Systemic Institutions.

<sup>2</sup> Restructuring options are policies that ensure and achieve continuity of critical functions of a failed institution. Specialized tools may be needed for critically important functions by way of a sale or transfer of the shares in the financial institution or of all or parts of the institution's business to a third party, either directly or through a bridge institution, and/or an officially mandated creditor-financed recapitalization of the institution that continues providing the financial functions.

<sup>3</sup> Liquidation options are tools that provide for the orderly closure and wind-down of all or parts of the financial institution's business in a manner that protects insured depositors, insurance policyholders, investors and other retail customers.

- (i) **Liquidation:** This is the simplest form of resolution that protects the insured depositors, insurance policyholders and investors within defined limits. In liquidation, the financial institution is declared insolvent, closed, its license is withdrawn and insured depositors/insurance policyholders/investors are paid off. A liquidator or receiver is appointed, which liquidates all assets and pays the proceeds on a pro rata basis to the creditors in a manner that respects hierarchy of claims in liquidation. In countries providing deposit insurance, the depositors are paid depositor claims up to an agreed amount and the deposit insurer may stand in their place in the hierarchy of claims. This tool is best suited where other resolution options may turn out more costly than the winding up of the financial institution. While liquidation provides a strong financial discipline on various stakeholders and ensures market discipline, the process is generally long drawn and locks up money of non-depositor creditors for months or years.
- (ii) **Purchase and Assumption (P & A):** This is one of the most efficient methods for resolving a troubled financial institution. The failed institution is closed, shareholders are wiped out, the license is revoked, and the failed financial institution's performing assets are sold to an acquiring institution that also assumes a corresponding amount of the failed institution's liabilities. This option provides continuity of services, protect the public money and at the same time protect the interest of depositors, other creditors and counterparties, whose exposures to the failing institution are replaced by claims on a stronger institution. This is also favored by the authorities as it provides the depositors access to their accounts without involving the insurance fund to pay out.

There are several variations on P & A transactions, such as:

- (a) **Basic P & A** – The private sector purchaser generally takes on only limited assets, usually cash and cash equivalents, and matching liabilities consisting mainly the insured deposits, either whole or part.
- (b) **Whole bank P & A** – The private sector purchaser or the acquirer purchases the entire portfolio of the failed financial institution on an “as-is” basis with no guarantees. Such transaction minimizes the cash outlay and reduces the assets held for future liquidation.
- (c) **Loan Purchase P & A/Modified P & A** – In addition to cash and cash equivalents, the acquiring institution will also acquire the performing loan portfolio and/or the mortgage loan portfolio of the failing financial institution.
- (d) **P & A with Put option** – In order to create a greater incentive for acquirers to bid for a failed financial institution's assets, the resolution authority can provide a “put” option on some of the transferred assets. This would allow the acquirer to

have a certain period of time, such as 60 or 90 days, to put back to the resolution authority assets it determines it does not want to keep. Such option could, however, lead to deterioration in value of put assets due to lack of attention, thereby making them harder for the resolution authority to market or collect later.

- (e) *P & A with Asset Pools* – This tool offers asset pools, divided into separate pools of like loan assets such as loans within the same geographic location or with the same payment terms. The pools could also be divided into performing and non-performing loans. The pools can be marketed separately. Bidders are thus able to bid on the parts of a failed financial institution’s business that fit best with their own business model. This arrangement allows for marketing to a great number of potential acquirers, which can lead to a greater number of assets being transferred.
- (f) *Loss Share P & A* – The acquirer and the resolution authority enter into an agreement to share any future losses on a defined set of assets. By limiting the risk for the acquirer, the resolution authority may be able to attract more bidders for the purchase of the failed financial institution’s assets.
- (iii) **Good Bank – Bad Bank method:** This method entails splitting of the failed financial institution into two, i.e. the good bank and the bad bank. The former contains privileged liabilities and good and performing assets (that are systemically important or have franchise value) and the latter takes the remaining liabilities and toxic assets. The good bank is transferred to the newly licensed institution or to one or more sound financial institutions willing to acquire it and the bad bank is liquidated and wound down. This method is different from Purchase and Assumption tool in that the Good Bank-Bad Bank always preserves the banking business, while the Purchase and Assumption do not keep the business unit going. This tool can also be used to facilitate resolution of a seriously troubled, but still solvent, problem financial institution.
- (iv) **Bridge bank<sup>1</sup>:** This is an interim solution where the authorities transfer the performing operations and functions of the troubled bank or financial institution together with its liabilities to a bridge institution. The failing financial institution is then closed and liquidated. This tool allows the resolution authority to “bridge” the gap between an institution’s failure and the time when a suitable purchaser is found. It also allows the resolution authority to leave behind any contingent liabilities or off balance sheet obligations in the liquidated institution. This involves temporary

---

<sup>1</sup>“Bridge banks” or “bridge institutions” are temporary institutions created by the resolution authority to take over and continue certain critical and viable operations of a failed financial institution during the resolution process for a limited period, with a view to onward sale to the private sector when market conditions stabilise.

administration either by the government or the resolution authority and also receives external support and funding for carrying on its functions. This tool may be attractive in particular for large and complex financial institutions, where due diligence examination of assets and liabilities by a private sector purchaser may take time and where it is utmost important to continue the critical services provided by the financial institution.

- (v) ***Bail-in within resolution*** – Bail-in is a statutory power of the resolution authority to restructure the liabilities of a distressed SIFI by converting and/or writing down unsecured debt into equity. It differs from contractual contingent capital instruments with write-off or conversion features (such as convertible bonds or CoCos). While both involve creditor-financed recapitalization, CoCos are private financial contracts with principal and scheduled coupon payments that can be automatically converted into equity or written down on going concern basis when a pre-determined trigger event occurs, whereas bail-in is a statutory power used on a gone concern basis that enables resolution authorities to write down or convert in the order – any contractual capital instruments that have not already been converted to equity, subordinated debt or unsecured senior debt.
- (vi) ***Temporary Public Ownership*** - This tool involves assuming ownership of a financial institution by the government. In the process, the troubled financial institution is preserved as a going concern, but effectively requires the government to guarantee the obligations of the failed institution and may require the government to inject new equity into it. This potentially undermines the public finances. This is a “tool of last resort”, which may be most appropriate if the financial system is highly concentrated and there are practically no suitable options for a sale to private purchaser.

#### *Resolution tools for FMIs*

**4.74** FMIs are different from other players in the financial system. FMIs will typically have rules and procedures which are binding on their participants and which can enable them to establish arrangements to recover from financial shocks. For example, Central Counterparties (CCPs) have rules and procedures to allocate uncovered losses. It is, however, possible that an extreme and unforeseen event could create a situation where an FMI’s resources, rules and procedures may not be sufficient for it to remain viable as a going concern. In order to achieve the objective of effective resolution framework, the proposed FRA also needs to have appropriate tools and powers specific to resolve FMIs.

**4.75** In cases of FMIs that do not principally take on credit risk (such as TRs), the appropriate tools for their resolution would be the use of transfer powers to transfer some or all of the FMI's functions and operations to one or more third parties, either directly or through a bridge institution. Alternatively, the FMI could be placed under statutory management, administration or conservatorship, leading to direct control under the resolution authority. Such administration or conservatorship would continue till the time they can be transferred or wound down in an orderly manner.

**4.76** FMIs that take on credit risk as part of their services, such as CCPs, SSSs, are generally required to have clearly defined rules and procedures to manage a particular default. It involves maintenance of margin requirements, a default fund and liquid resources to cover its current and potential future exposures and liquidity needs. These FMIs generally have in place "waterfall" arrangements that determine the order in which different types of resources are drawn upon to absorb losses. This arrangement works by drawing first on margins, collateral and default fund contributions of the defaulting participant and subsequently on default fund contributions belonging to the non-defaulting participants.

**4.77** The primary resolution tool for such FMIs includes loss allocation mechanism supported by statutory powers. This could be implemented through haircutting of margin and by enforcing any outstanding obligations under the FMI's rules to replenish default funds or respond to cash calls. Another important tool is the bail-in mechanism. In case if a FMI has issued debt securities or has significant loans or intra-group balances, loss allocation could potentially also extend to bail-in of these liabilities. Moreover, as in the case of other FMIs that do not take on credit risk, the transfer tool could be used by the resolution authority to transfer some or all of the FMI's operations or ownership to a third party purchaser or, if no appropriate purchaser is available, to a publicly owned bridge institution for a temporary period prior to eventual sale or wind-down.

#### *Resolution tool for insurance companies*

**4.78** Generally the traditional insurance activities and some non-traditional insurance activities that are no longer viable could typically be resolved through run-off and portfolio transfer procedures. Run-off is the process of discontinuing the writing of new business while continuing to administer existing contractual policy obligations for in-force business. Claims are paid against the existing reserves of the insurer. A run-off can be solvent or insolvent, depending on the sufficiency of reserves and capital to pay off all claims. Portfolio transfers enable the resolution authority to transfer all or certain of insurer's business or contracts of

insurance and reinsurance to another insurer without the consent of each and every policyholder subject to approval by the regulatory and resolution authorities. Such transfers may allow the maintenance of insurance contracts beyond insolvency and therefore safeguard the interest of the policyholders to a maximum.

**4.79** It may not, however, be possible to rely on these traditional tools in all circumstances, especially where the business model of the insurer is complex. Run-off and portfolio transfer tools may not be sufficient to mitigate the systemic impact of non-viable large, complex insurance group engaging in other NTNI activities that may involve bank-like leverage and maturity transformation intermediation.

**4.80** In addition to normal winding-up tool and those mentioned above, the resolution tools, alike those for banks, such as bridge institution and restructuring of liabilities tools could act effectively for maximizing the value for policyholders as a whole and providing continuity of insurance coverage. The liabilities restructuring tool would allocate losses to creditors and policyholders in a way consistent with the creditor hierarchy, subject to safeguards detailed later (para 4.166). However, this could take variety of forms – reducing future benefits of policyholders, reducing the value of contracts upon surrender, reducing or terminating guarantees such as guaranteed sum assured or annuity rate provided, converting an annuity into a lump sum payment, converting insurance liabilities from one type of insurance liability into another (such as, with profits into unit linked) in order to facilitate sale of business or ensuring its continuity, etc.

**4.81** *The FSLRC has recommended adoption of at least three resolution tools by the resolution authority. These include – resolution by purchase and assumption, resolution by bridge bank, and resolution by temporary public ownership. The draft code on resolution, suggested by the Commission, also lays down certain conditions for triggering these tools for resolution. As regards use of temporary public ownership, the Commission has recognized that this tool should be used only as a last resort by the resolution authority and with the only intention to maintain financial stability. This tool should typically be used for a SIFI, including banking service providers, and the resolution authority must consult and obtain the permission of the FSDC in order to use the TPO tool.*

**4.82** **The Group recommends that with a view to carrying out orderly resolution of failing financial institutions and FMIs without taxpayers' support, the FRA should have a variety of resolution tools mandated by the proposed statute, such as,**

liquidation; purchase and assumption; bridge institution; good-bank and bad-bank; bail-in and temporary public ownership, which can be used flexibly, either singly or in combination with others, to resolve a financial institution and preserve its critical functions. *(Recommendation 13)*

**4.83** As FSB, IAIS, CPSS and IOSCO are in the process of preparing guidance for extending Key Attributes to cover a wider range of market participants in the financial sector, including FMIs, insurance companies and other non-bank financial institutions, the Group recommends that while the proposed financial resolution framework would be applicable for all financial institutions, including FMIs, a detailed framework may be formulated at a later stage for non-bank financial institutions based on the policy documents and guidance that are yet to be issued by the FSB and other international standard setting bodies. *(Recommendation 14)*

#### *Issues in bail-in resolution tool*

**4.84** The bail-in tool is aimed at recapitalizing a failed SIFI or its corresponding bridge bank by converting creditors into equity holders. In case of a large institution, it may be hard to use traditional tools like selling the entity to other financial entities or to a third party purchaser. Bail-in allows restructuring of a failed SIFI's liabilities and recapitalization of the institution from within rather than relying on public sector capital injections. Bail-in acts as a complementary tool to resolve SIFIs by providing a funding option.

**4.85** When a bail-in by creditors takes place, legal certainty and predictability are essential. The existence of statutory bail-in tool does not prevent the financial institutions from issuing instruments that write-off or convert contractually, nor do they prevent national authorities from requiring them. However, the statutory framework for bail-in within resolution might create incentive for financial institution to issue such contractual instruments that would reinforce their capacity to recover from distress without going into resolution.

**4.86** The Swiss Financial Market Supervisory Authority (FINMA) has introduced bail-in as one of the resolution tools for resolving a SIFI. The special resolution regime of Switzerland makes all liabilities – with a few clearly defined exceptions, which include all privileged claims (such as the claims of employees in particular), insured depositors, secured claims and claims after applying offset – subject to compulsory conversion of debt into equity or compulsory write down of claims. Thus, structured products, short-term debt and uninsured

depositors are also potentially subject to bail-in, provided all other debt has already absorbed losses.

**4.87** The European Union's draft Banking Recovery and Resolution Directive, published in June 2012, provides bail-in as one of the preferred resolution tool, which will be applicable to all debt, except the secured liabilities, repos, guaranteed deposits, short duration liabilities (less than one month to maturity) and derivatives cleared through a CCP. The Directive mandates that at least 8 per cent of the bank's total liabilities should be subject to bail-in. In case the converted debt is not sufficient to absorb the losses, the resolution fund would be utilized to the extent of 5 per cent of the failed bank's total liabilities. Canada and United Kingdom are also following suit in implementation of bail-in tool in respect of SIFIs only. However, the deposit liabilities are getting exempted from the coverage.

**4.88** While bail-in may be an effective resolution tool, the threat of bail-in powers could put strains on both the distressed bank's funding as well as other banks' funding, increasing the cost of replacing the maturing debt. This is more so in times of stress when investor confidence is fragile. Structurally elevated funding costs over a long period of time could lead to lower bank margins and earnings, and could even reduce build-up of capital buffers. They could prompt the bank management to seek riskier assets to offset expensive funding or extensively rely on central bank funding. This in turn could have serious negative repercussions for credit supply and real economic activities.

**4.89** Higher funding costs for unsecured debt could result in changes in bank's liability structures by shifting to short-term debt and secured borrowing, which are likely to be excluded from bail-in. Such a shift may go against the Net Stable Funding Ratio (NSFR) of the Basel III framework as well as result in a higher maturity mismatch and consequent liquidity and interest rate risks. It may also lead to a shift by creditors towards holding deposits instead of unsecured debt, thus making the resolution very costly especially if there is general depositor preference.

**4.90** In situations where the senior debt instruments of a troubled bank are held by other financial institutions, such as other banks or mutual funds or pension funds or insurance companies, a write-down of senior debt can trigger systemic repercussions that an effective resolution regime is required to avoid. In the event of uninsured depositors coming within the scope of bail-in, a bank run could be triggered and even lead to contagion and systemic risk.



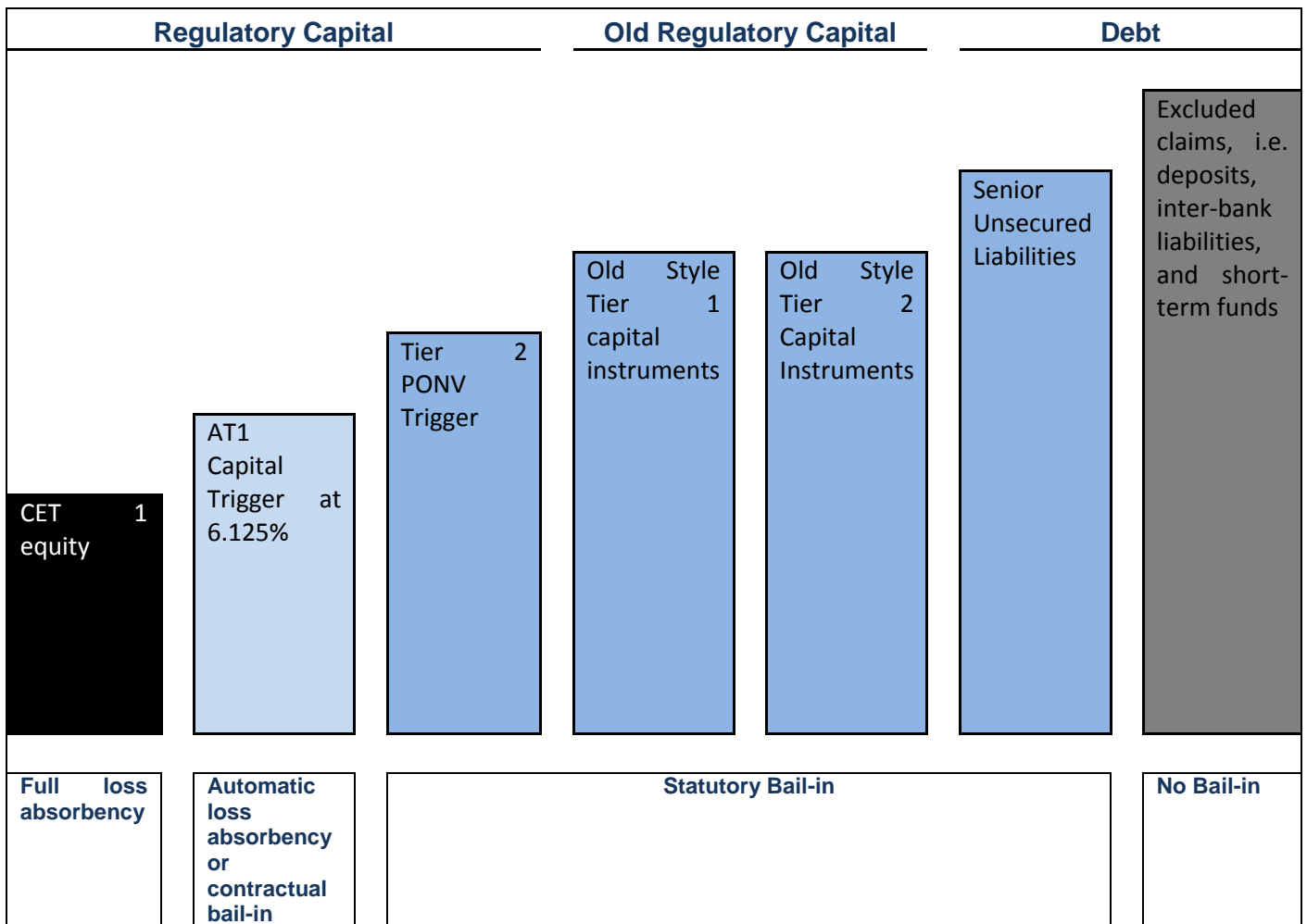
**4.91** As bail-in allows the resolution authorities greater flexibility in their response to the failure of large and systemically important financial institutions (SIFIs) in restoring viability and disincentivize becoming “too-big-to-fail”, the Group recommends taking into account all factors, adopting the bail-in mechanism as a resolution tool in case of global systemically important banks (G-SIBs)/domestic systemically important banks (D-SIBs). *(Recommendation 15)*

**4.92** The Group recognizes that practical implications of bail-in across jurisdictions still need to be tested. Since banks dominate the financial market in India, inclusion of deposit liabilities, inter-bank liabilities, and short-term debt (such as repo), in addition to capital instruments, within the ambit of bail-in may induce a run and result in instability in the financial market. Moreover, the Indian banks have not been permitted to raise unsecured debt in the form of corporate bonds except the borrowings under Medium-Term Note programme, Certificate of Deposits (CDs), short-term repos, infrastructure bonds and inter-bank borrowings. Inclusion of such instruments, in the absence of contractual clause and likely different legal frameworks across jurisdictions, may raise practical problems in actual implementation.

**4.93** The Group, further, recommends that the bail-in framework should cover the capital instruments (additional Tier 1 and Tier 2) as well as other unsecured creditors, while deposit liabilities, inter-bank liabilities, and all short-term debt, which if subjected to bail-in can induce financial instability, would be excluded from bail-in. In order to minimise the uncertainty generated by discretionary use of bail-in power and to avoid uncertainty among unsecured creditors, the bail-in power should be statutorily placed with the FRA. With developments in resolution mechanisms internationally, this tool may be extended to other financial institutions. *(Recommendation 16)*

**4.94** Chart 4.1 below shows the sequence in which the bail-in would be applied to the financial institution debt categories:

Chart 4.1: Application of Bail-in



**Note:** The height of bars in the Chart indicates the seniority of claims in liquidation, i.e., the bar with least height will absorb the losses first and the bar with more height will absorb the losses last.

**Source:** Resolution of Global Systemically Important Banks – FINMA Position Paper, August 2013.

*Temporary public ownership*

**4.95** In situations where a financial institution, deemed to be systemically important, comes into financial distress and has the potential to trigger financial instability and cannot be resolved by sale to a third party because of its sheer size, can best be resolved as a last option by Government taking control of the financial institution. This essentially would result in transfer of shares to the Government. There are various advantages as well as disadvantages of this tool. While the execution of this tool can occur without any delay, it protects all creditors and maintains public confidence in a crisis like situation. Continuation of the financial institution’s operations ensures no disruption in the payment system even.

**4.96** On the other hand, blanket protection of all creditors erodes market discipline and leaves no incentives to the creditors to monitor the financial institution. This being the case, it enhances the level of moral hazard and the creditors face incentives to take on greater risks.

**4.97** Several jurisdictions authorize the use of TPO. The Special Resolution Regime (SRR) of United Kingdom provides a TPO tool as an additional resolution tool. It involves the Treasury to take control and ownership of a failing banking institution through the transfer of shares, in order to provide a stable platform for restructuring. This tool is preferred where the Treasury has already provided a significant amount of public money to the failing institution or where it is considered necessary to preserve stability of the UK's financial system. The EU's draft proposal on Recovery and Resolution Directive also provides for a nationalization option, preferably a last one, for resolving a bank to avoid contagion and reduce risk to financial stability.

**4.98 As temporary public ownership (TPO) may be important for ensuring financial stability in exceptional situations, the Group recommends that the Government of India (Ministry of Finance) may, on recommendation by FSDC, be empowered to place a financial institution under TPO and control on financial stability considerations and only if such action is necessary to protect public interest. There should be intensive consultation with the concerned regulator and the FRA before placing the institution under TPO. This tool should be only temporary in nature till a viable alternative such as, sale or transfer or merger is found. (Recommendation 17)**

#### ***Specific resolution powers***

**4.99** Operation of any one tool on a failing financial institution would require a host of resolution powers to be vested in the resolution authority. Taking into account the international experience in this regard as also the requirements defined under the FSB Key Attributes, the FRA would need to have the following powers mandated by the statute so as to enable the authority to initiate resolution actions in an effective manner:

- (i) Power to remove any chairman, director, chief executive officer or other officer or employee of the financial institution
- (ii) Power to appoint an administrator to take control of and manage the affected financial institution with the objective of restoring the institution, or parts of its business, to ongoing and sustainable viability
- (iii) Power to override rights of shareholders of the financial institution in resolution, including requirements for approval of shareholders of particular transactions, in

order to permit merger, acquisition, sale of substantial business operations, recapitalization or other measures to restructure and dispose of the institution's business or its liabilities and assets

- (iv) Power to transfer or sell whole or part of assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, of a failing financial institution to a solvent third party institution or a bridge institution, without any requirement of consent from the shareholders or creditors;
- (v) Power to establish one or more temporary bridge institution to take over and continue operating critical functions and viable operations of a failed financial institution;
- (vi) In case of insurance firms, the resolution authority should also have the powers to undertake a portfolio transfer moving all or part of the insurance business to another insurer without the consent of every policyholder, and also impose restrictions on insurers in resolution on writing new business, while continuing to administer existing contractual obligations (i.e., carry out a systematic run-off).
- (vii) Power to transfer non-performing loans or difficult-to-value assets to either newly established or existing asset management vehicle; and
- (viii) Power to impose a moratorium with suspension of payments to unsecured creditors and customers and a stay on creditor actions to attach assets or collect money or property from the firm, while protecting the enforcement of eligible netting and collateral arrangements.

## Funding of Resolution

**4.100** The funding of resolution is vital to preserve the functioning of a financial institution. Key Attribute 6 requires jurisdictions to have statutory or other policies in place for adequate arrangements for funding resolution from private sources (such as privately-financed deposit insurance or resolution funds) or temporary public funding with mechanism for ex post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm. In order to reduce moral hazard, any provision of temporary public funding for maintaining essential functions so as to accomplish orderly resolution, should be subject to conditions and mechanisms for recovery from the firm itself, its shareholders and uninsured creditors or from the financial system more widely. Any temporary public funding should be exercised only if it is necessary to foster financial stability and to achieve orderly resolution and private sources of funding have been exhausted or cannot achieve the objectives.

**4.101** International experience regarding funding arrangements for resolution of large and complex financial firms is in an early stage so far. Discussions are currently on-going within the EU on the merits of general bank resolution funds, financed ex ante via industry contributions. The EU Directive on Recovery and Resolution has placed a proposal before the member countries that aims to establish arrangements for financing resolution measures, i.e., a European System of Financing Arrangements that would ensure that all financial institutions that operate in the European financial markets are subject to equally effective resolution funding arrangements and contribute to the stability of the single European financial markets. The European System of Financing Arrangements consists of national financing arrangements, the borrowing between national financing arrangements and the mutualisation of national financing arrangements. Accordingly, each member state would set up resolution financing arrangements to ensure efficient implementation of resolution tools and powers. In this respect, any losses and costs incurred by the employment of the financing arrangements shall be consecutively borne by shareholders and the creditors of the failed institution. The financing means would comprise an ex ante contribution as well as the possibility to raise extraordinary contributions. They would also include arrangements to contract borrowings on the capital markets or with financial institutions. The proposed Directive determines the optimal amount of money that needs to be available in each member state and presents a model for ex ante contributions to the financing arrangements. According to the model, the calculation of contributions depends on the decision of the member state whether or not to use the funds of deposit insurance scheme for financing resolution measures and the amount of institution's liabilities. National financing arrangements will have the right to borrow from all other financing arrangements within the EU when the amount raised is not sufficient to finance the resolution. Each national financial arrangement has to contribute to the financing of group resolution together with the national financing arrangements of the other member states, in accordance with their shares.

**4.102** Currently, the United Kingdom does not have a general bank resolution fund and the bank levy, which has recently come into force, is a purely fiscal measure and is not intended specifically to fund public costs for resolving banks. In contrast to certain other jurisdictions (notably, the United States where the Dodd-Frank legislation explicitly prohibits public financial support), the UK framework implicitly acknowledges that in certain situations where systemic stability is threatened, public support for ailing banks may be unavoidable. The Banking Act, 2009 allows Her Majesty's Treasury (HMT) to access the consolidated fund in order to provide financial assistance to banks quickly, if HMT considers that the need for

funds is too urgent to permit arrangements to be made for the provision of money by parliament. Under the SRR, the Financial Services Compensation Scheme (FSCS - the UK's deposit guarantee scheme) may participate in funding resolution. The role of the scheme is not limited to repayment in liquidation. FSCS may contribute to the funding of SRR resolution transactions up to an amount not exceeding the cost to the FSCS, net of recoveries, of paying out to insured depositors in an insolvency. The FSCS is funded ex post and has access to HMT finance. Normally, the costs for resolution would be met by sales and other proceeds from the bank itself. However, if additional funds are needed, the FSCS has access to liquidity support via loans from the National Loan Fund.

**4.103** Spain has set up a Fund for Orderly Bank Restructuring (FROB) with the goal to manage the restructuring and resolution processes of credit institutions, aimed at ensuring the stability of the financial system, depositor protection and an efficient use of public resources. The objective of the FROB is to assist and foster the reorganization of the Spanish banking industry. The FROB has legal personality and full public and private capacity to implement its objectives. The initial capital of the FROB amounts to €9 billion, of which €2.25 billion were contributed by the Deposit Guarantee Fund (FGD) and the rest by the State. The FROB can issue securities guaranteed by the state (and/or it can seek other funding) up to three times its capital (€27 billion), but it can leverage up to 10 times (thus reaching a total capacity of €99 billion) with the approval of the Ministry of Finance and Public Administrations. In 2012, the capital of the FROB was raised to €15 billion, though its total borrowing capability has remained unchanged.

**4.104** Several issues arise while designing a fund for resolution. First, whether the fund be set up as ex ante fund or ex post fund. Views amongst countries on pre-funded, general resolution funds appear to vary. Some are opposed, perceiving increased moral hazard (as bank creditors might regard such funds as an implicit guarantee that they would be rescued in all cases, so they might change their behaviour in ways contrary to the public interest) while observing that amounts raised could be insufficient in any event. Opponents also note that fiscal costs cannot be completely eliminated (much of a pre-fund would sit as government paper, whose large-scale liquidation at the point of requiring the funds could nudge up rates). Conversely, proponents attach value to the political signalling effect of raising general resolution funds, ex ante and via industry contributions, and some countries have begun to build up such funds. The European Commission has taken the view that resolution funds should be built up on the basis of contributions from banks ex ante. Fully ex post funded schemes may imply upfront taxpayer funding and therefore increase the risk

that banking failures would be accompanied by broader negative economic impacts. Such an approach may prove pro-cyclical, placing strains on the public budget during a financial crisis when the State is least equipped to provide additional financing.

**4.105** Second issue is, whether there should be a single fund for depositor protection and resolution. Some argue that single fund makes economic sense as deposit insurance funds are used in the event of bank liquidation and such pay-outs may not be required if bank is restructured on sound lines. However, it partly depends on whether the deposit insurer is also the resolution authority. Further, there is the risk of underfunding the resolution if one only makes use of deposit insurance fund for resolution purposes. If the deposit insurance agency has been granted additional mandate, then the fund base needs to be expanded to deal with the additional mandate. Cover both resolution and deposit insurance under one fund would also require that the ranking of claimants is clear and adequate. Separate deposit insurance and resolution funds are considered beneficial from an accounting perspective as one can then clearly identify resolution costs.

**4.106** *The FSLRC has recommended creation of a resolution fund by the resolution corporation, funded through premium from covered service providers that would be proportional to their financial position, for the purpose of resolution related expenses including administrative expenses, payment of compensations to creditors, etc. The Commission has also mandated the resolution corporation to provide insurance to the consumers of eligible covered service providers. The draft Code also enables the resolution corporation to terminate the Corporation insurance of a covered service provider in certain circumstances including when the covered service provider is determined to be at critical risk to viability. In exceptional circumstances, the Resolution Corporation could avail a line of credit from the Central Government for a period of five years. The Corporation may meet its repayment obligations against that line of credit by claiming to be a creditor of the first priority of the particular covered service provider that is under liquidation or dissolved.*

**4.107** Considering various options, the Group recommends that:

- (i) the resolution fund would be different from deposit insurance fund and other protection funds;
- (ii) it would be pre-funded and built over time through ex ante premiums determined on risk-based assessments;

- (iii) in the event a systemic institution is under stress, sufficient backstops, including temporary funding support from the Government, with safeguards, may be provided to ensure adequate liquidity;
- (iv) the FRA may raise funds from the market through issue of bonds; government guarantee may have to be extended, if required;
- (v) the resolution fund would have arrangements to meet shortfalls in fund through ex post levies on the financial institutions and FMIs;
- (vi) the fund would also be built up from recovery of assets from failed institutions; the recoveries may, however, first accrue to deposit insurance or other protection funds if and to the extent they have been used instead of resolution fund;
- (vii) the fund could build a core base adopting a suitable methodology for collecting a surcharge (one time capital infusion) from financial institutions and FMIs;
- (viii) the fund would maintain separate accounts for different types of financial institutions, viz., banks, insurance firms, securities firms, FMIs, as the premium rates and size of fund requirement for different sectors would vary; and
- (ix) inter-fund borrowing to meet shortfalls in one or the other fund would be allowed. (*Recommendation 18*)

**4.108** There is limited experience available internationally on how big the resolution fund should be. While there is no well-established good practice for resolution funds, the typical target size for deposit insurance funds could range from about 1–2 per cent of insured deposits in large systems to 4–5 per cent in smaller systems, where the aim is to cover 2–3 mid-sized banks and 4–6 small banks. The target size also varies with the level of the institutional environment and resolution framework, including the effectiveness of prompt corrective action and early intervention mechanisms. The Group feels that the resolution fund in case of banks and other financial institutions could be relatively small to cover some individual failures.

#### ***Deposit insurance and other protection funds***

**4.109** Deposit Insurance and Credit Guarantee Corporation was set up in 1961 with an objective of providing protection to small depositors. The size of deposit insurance fund currently maintained by DICGC stands at ₹ 37,766 crore as on September 30, 2013, which works out to 1.7 per cent of insured deposits. SEBI also maintains an investor protection



fund. In case a stock broker is declared defaulter, the interests of the investors are protected through the Investor Protection Fund (IPF)/Customer Protection Fund (CPF) set up by the stock exchanges. At present, National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) are providing protection subject to a maximum of ₹15 lakh per client/investor. As on October 31, 2013, the corpuses of IPF at BSE, NSE and MCX-SX were ₹ 647.70 crore, ₹ 380.97 crore, and ₹ 10.89 crore respectively.

**4.110 In order to maintain the sanctity of existing deposit insurance and other protection funds, the Group recommends that the deposit insurance fund maintained presently by the DICGC and other funds, if any, maintained by other regulators for protection of insurance policy holders and investors may be kept separate within the FRA. Only those funds will be brought within FRA, which will be used for consumer protection pursuant to resolution action and not during stage of early intervention by the regulator/supervisor. Both resolution and depositor/investor protection funds should be built up simultaneously till a well-defined target level is reached. It is also recommended that the accretion to both funds by way of premium or any other method of contribution should be exempted from tax. (Recommendation 19)**

**4.111 The Group feels that in view of the ground reality in India that a large proportion of depositors are small depositors (94% of depositors currently hold deposits of less than or equal to Rupees 100,000 – the present deposit insurance coverage limit) and large presence of banking network that is also being used to promote financial inclusion, it is important that deposit insurance remains an important and specialized component of the proposed resolution framework. The deposit insurance framework existing at present has remained unchanged for a long time (as pointed out by several committees in the past). The Group recommends that along with setting up of a resolution framework, reforms in deposit insurance may also be taken up to bring the system on the lines expected by international benchmarks, viz., Core Principles for Deposit Insurance Systems. Illustratively, the areas where reforms in deposit insurance in India are important to improve its effectiveness are – reduction in timeframe for reimbursing depositors, collection of depositor information in a ‘single customer view’ format, review of coverage limit, manner of sharing of recoveries, exemption from taxation of premium, review of instruments permissible for investment, back-up funding to support shortfalls in deposit insurance fund and technologically advanced data systems and payment methods. (Recommendation 20)**

## Preventive and Contingency Planning

**4.112** Contingency planning is important both for regulators/supervisors and the resolution authority as the former implements preventive measures within the early intervention framework and for the latter in the preparation for dealing with failed financial institutions.

**4.113** The PCA framework is a methodology to take early intervention by the regulators/supervisors. However, there is a need to require the financial institutions themselves to be better prepared to recover from situations of severe stress. This could be achieved by requiring the institutions to formulate “Recovery and Resolution Plans (RRPs).” Such planning can make available all types of information about the financial institution/group to the regulators/supervisors and the resolution authority. At the same time, the resolution authority needs to prepare a Resolution Plan for resolving the failing financial institution in terms of the objectives of financial resolution framework. Preparation of a resolution plan requires extensive information and data about the business and operational structure of the financial institution/group.

**4.114** RRP focus on solving institution-specific problems, but not systemic problems. RRP provide in advance the measures, in the event of a crisis, that a financial institution could take to recover as a going concern or the authorities could take to resolve it in an orderly fashion. The RRP aim to ensure that the financial institutions:

- assess and document the range of credible recovery options that would be available to them under severe stress scenarios taking into account the nature, complexity, interconnectedness, level of substitutability and size;
- enable the timely and quick implementation of these recovery options in a range of stress situations;
- supply the regulatory authorities with information and strategic analysis on their businesses, organisations and structures to enable the authorities to carry out an orderly resolution in case the recovery options are ineffective and not feasible.

There are two aspects to RRP:

- (i) Recovery Plans; and
- (ii) Resolution Plans

### *Recovery plans*

**4.115** Recovery plan is a plan, developed and maintained by the financial institution, detailing the early action it would take to restore its long-term viability if the institution’s

financial situation deteriorated due to idiosyncratic and market-wide stress. The recovery plan in respect of financial institution would ideally be ensuring financial continuity – i.e. to maintain adequate capital and liquidity. In particular, the recovery plans aim at preserving the continuity of critical financial services under severe adverse conditions and identifying the necessary measures to ensure that the group financial institution remains a “going concern”.

**4.116** Recovery plans could help regulators and supervisors in identifying the appropriate actions that can restore the viability of financial institutions at an early stage. As recovery plans would be prepared by financial firms, this process would help them in reviewing their operations, risks, and necessary actions in a problematic situation. Recovery plans thus would increase the preparedness and awareness of both firms and their supervisors for dealing with problems at an early stage.

**4.117** Based on the guidance documents issued by UK’s FSA (now PRA) and US FDIC and Board of Governors of the Federal Reserve System, and also taking into consideration the structure and operations of Indian banks, the Group has prepared an indicative document on preparation of Recovery Plan by banks, which is given in **Annex 5**. This document focuses on the key elements/components that a Recovery Plan of a bank should have.

**4.118** Recovery planning would enable a financial institution to restore its financial strength and viability through own efforts, i.e. before the conditions are met for regulatory authorities to enforce recovery measures. The institutions may, therefore, require calibrating triggers for initiation of recovery measures in a manner that negates the initiation of regulatory/supervisory intervention measures. This means that the institution would need to be alert before PCA trigger levels so that there is time for the recovery plan to have an effect. This process could be aided by development of early warning signals prior to an actual breach of a trigger for alerting the financial institution’s management to emerging signs of distress.

### ***Resolution plans***

**4.119** The resolution plans or “living wills” are prepared by the resolution authority in consultation with regulators/supervisors and concerned financial institution during normal times. The plan sets out the strategy for resolving the financial institution in a range of plausible scenarios. The objective is to formulate/decide in advance on a feasible strategy and detailed roadmap that facilitates the effective use of resolution powers to resolve a failed

financial institution or group in a manner that minimises the impact on financial stability without exposing taxpayers to loss, while simultaneously protecting the systemically important functions.

**4.120** The resolution plan, therefore, should include a substantive resolution strategy agreed by the top management of financial institution and an operational plan for its implementation and identify in particular:

- (i) financial and economic functions for which continuity is critical;
- (ii) suitable resolution options to preserve those functions or wind them down in an orderly manner;
- (iii) data requirements on the financial institution's business operations, structures and systemically important functions;
- (iv) potential barriers to effective resolution and actions to mitigate those barriers;
- (v) actions to protect insured depositors and ensure the rapid return of segregated client assets; and
- (vi) clear options or principles for exit from the resolution process.

**4.121** *The FSLRC has recommended preparation of restoration plan and resolution plan by all covered service providers as soon as the regulator makes a decision that the covered service provider has reached the 2<sup>nd</sup> stage (moderate risk to viability) and 3<sup>rd</sup> stage (material risk to viability) respectively, of the proposed PCA framework. As per the Commission, while the restoration plan needs to be approved by the regulator, the resolution plan needs to be approved by the Resolution Corporation.*

**4.122** The Group recommends that:

- (i) the RRP, to start with, will apply only to those financial institutions that could be systemically significant or critical if they fail;**
- (ii) RRP requirement will also apply to all financial groups/conglomerates, whether they are systemically important or not;**
- (iii) the RRP regime could be extended to other financial institutions in a phased manner;**
- (iv) the recovery plan will be prepared on a regular basis by the institutions as per a pre-approved format and will be approved by the respective regulator;**
- (v) the resolution plan containing resolution strategy to be adopted for resolving the institution will be prepared by the institution and approved by the FRA in consultation with the concerned regulator;**

- (vi) the regulator/supervisors in consultation with the FRA may prescribe varying levels of collection and sharing of information depending upon the size and complexity of the financial institution; and
- (vii) the resolution plan must be reviewed annually, or earlier if considered necessary, by the resolution authority so as to take into consideration the incremental developments in the institution as well as the regulatory/supervisory norms. *(Recommendation 21)*

#### *RRP for FMIs*

**4.123** The FMIs are considerably different from any other form of financial institutions. Since they play a very critical role in the financial system and also that there are difficulties in transferring critical services from a failed FMI to a viable FMI owing to scarcity of such entities and their capabilities, maintaining the continuity of an FMI's critical services, even in times of extreme market-wide stress, is particularly important and central to financial stability. Thus having a strong recovery plan is a vital element in enabling the continued provision of critical services. The PFMI require that FMIs have effective strategies, rules and procedures to enable to recover from financial stresses.

**4.124** The purpose of recovery plan for FMIs is to document the information and procedures necessary to allow the FMI to effect recovery and continue to provide its critical services when its viability is threatened. The plans enable the FMIs, its participants and other relevant stakeholders to prepare for extreme circumstances, and accordingly increase the probability that the most effective recovery tools to deal with a specific stress will be used.

**4.125** In order to ensure continuity of critical services provided by the FMIs, the systemically important FMIs may prepare RRP that would prescribe credible options to recover from extreme and severe stress scenarios. The plans may essentially prescribe methodology to allocate uncovered losses and liquidity shortfalls to direct participants, indirect participants, third-party institutions and/or owners on the basis of and to the extent they are permitted by ex-ante arrangements. *(Recommendation 22)*

#### *Criteria for determining systemically important financial institutions*

**4.126** There are various factors that drive a particular financial institution to be classified as systemically important, i.e. any problem or failure of such financial institution creates

financial instability. These factors – size of the institution’s balance sheet, its exposures to other financial institutions (interconnectedness), its role in facilitating wider market operations, complexity in its operations – are critical in judgement of a financial institution to be systemic in nature. It is rather difficult to define what is ‘systemic’ in statutes and may involve regulatory judgement.

**4.127** The Basel Committee on Banking Supervision (BCBS) issued, in November 2011, the rules text on the assessment methodology for global systemically important banks (G-SIBs)<sup>1</sup> and their additional loss absorbency requirements. Paragraph 14 of the G-SIB rules text states that “global systemic importance should be measured in terms of the impact that a failure of a bank can have on the global financial system and wider economy rather than the risk that a failure can occur. This can be thought of as a global, system-wide, loss-given-default (LGD) concept rather than a probability of default (PD) concept.” Consistent with the G-SIB methodology, the BCBS has, in October 2012, published the final policy proposals on dealing with domestic systemically important banks (D-SIBs) in a document entitled, “A framework for dealing with D-SIBs”<sup>2</sup>. The document provides that the identification of a D-SIB should be based upon the potential impact of or externality imposed by its failure on the domestic economy. The impact of a D-SIB’s failure on the domestic economy should be assessed in respect of bank-specific factors, i.e. size, interconnectedness, substitutability/financial institution infrastructure, and complexity. In addition, the national authorities could choose to also include some country-specific factors, such as size of bank relative to gross domestic product (GDP). The national jurisdictions also have the discretion as to the appropriate relative weights they place on these factors on national circumstances.

**4.128** Furthermore, the International Association of Insurance Supervisors (IAIS) has, in July 2013, published an assessment methodology<sup>3</sup> for identification of global systemically important insurers (G-SIIs) and a set of policy measures that will apply to them. The IAIS assessment methodology identifies five categories to measure relative systemic importance – non-traditional insurance and non-insurance (NTNI) activities, interconnectedness, substitutability, size and global activity. The IAIS has assigned different weights to each of the categories – 45% to NTNI; 40% to interconnectedness; 5% to substitutability; 5% to size and 5% to global activity.

---

<sup>1</sup> See <http://www.bis.org/publ/bcbs207.pdf>

<sup>2</sup> See <http://www.bis.org/publ/bcbs233.pdf>

<sup>3</sup> See <http://www.iaisweb.org/G-SIIs-988>.

**4.129** The Reserve Bank of India has issued, on December 2, 2013, a draft framework<sup>1</sup> for dealing with D-SIBs. It provides the methodology to be adopted by the reserve Bank for identification of the D-SIBs and also proposes regulatory/supervisory policies which D-SIBs would be subjected to. The assessment methodology primarily uses various indicators – size, interconnectedness, substitutability and complexity – for assessing the systemic importance.

**4.130** In view of the risks posed by SIFIs to the financial system, the parameters used for assessing systemic importance of D-SIBs could be employed by the respective regulators to determine the systemic importance of other domestic financial institutions in the Indian context. In this context, the Group recommends that other financial sector regulators should, based on the framework being developed by international standard setting bodies, formulate a framework for determining SIFI falling under their respective regulatory jurisdiction. (*Recommendation 23*)

#### *Improving resolvability*

**4.131** With the liberalization of the Indian financial sector over the years, there has been significant transformation in all sectors of the financial system, i.e. banking, non-banking finance, securities/investment business, and insurance. Each of these sectors has grown significantly accompanied by a process of restructuring among the market participants in the financial system. As a result, the Indian financial landscape has seen the emergence of FCs, i.e., financial services groups comprising a number of legal entities each operating in a different segment of the financial services sector. Generally, while the financial services entity is the parent entity of financial groups, in some cases, the industrial company is the parent entity.

**4.132** The Indian financial system, being dominated by banks, has expanded into non-banking activities with the main objective to diversify its balance sheet and reap the benefits and economy of scale and scope to enhance incomes. Over the years, the banks have set up subsidiaries in almost all non-banking financial areas, such as NBFCs, housing finance, factoring services, insurance, mutual funds, venture capital funds, pension funds, stock broking, merchant banking, etc.

**4.133** Such a structure has necessitated development of consolidated supervision of such financial groups since 2003 to facilitate assessment of risks in a holistic manner. Complex

---

<sup>1</sup> See <http://www.rbi.org.in>

structures can make assessment of risk difficult. Currently there have been discussions in various foreign jurisdictions that TBTF banks can cause large negative externalities to an economy. Switzerland for example is trying to get its largest banks, UBS and Credit Suisse Group, to scale back and reduce the risks they pose to Swiss taxpayers and thus improve resolvability assessment.

**4.134 With a view to reducing the impediments to resolution posed by complex financial institutions, the financial groups and the regulatory authorities should work together in reducing complexity in group structures, and ensure prudent, intra-group transactions and exposures. The financial institutions should identify areas in their existing organizational structure that could pose difficulties in consolidated risk management/monitoring and take suitable measures to reduce those complexities. (Recommendation 24)**

**4.135 Though the Indian financial sector regulators have been conservative in letting evolution of complex structures, the Group expects innovative developments and complexities that could evolve in the light of increased globalization and financial integration. In view of this, the Group recommends enabling the regulatory/supervisory authorities to have powers for taking measures, such as restructuring the financial institution's business practices and structure, for improving the resolvability of systemically important financial institutions. Such actions could form part of the early intervention mechanism. (Recommendation 25)**

#### *Holding company structure*

**4.136** The Working Group on Introduction of Financial Holding Company (FHC) Structure in India (Chairperson: Shyamala Gopinath), constituted by the Reserve Bank in June 2010, examined the advantages and disadvantages of the financial holding company model and the bank-subsidiary model from the regulatory and supervisory perspectives. It was conscious of the fact that regardless of the organizational forms, banks cannot be totally insulated from the risks of non-banking activities undertaken by their affiliates. On balance of advantages and disadvantages, the Working Group recommended that the financial holding company model should be pursued as a preferred model for the financial sector in India. This should also be extended to all large financial groups, irrespective of whether they contain a bank or not. One of the advantages of the FHC structure is the ease in resolution if any entity/group comes under stress.



**4.137** Internationally, the preferred resolution strategy for holding company structure with ownership in branches and subsidiaries and where resolution is led by a single authority is emerging to be Single Point of Entry (SPE). The SPE approach envisions the conversion of creditor claims to equity and then the downstreaming of equity from the holding company to weak or insolvent subsidiaries. This resolution technique requires sufficient creditors with loss absorbing capacity, shared services provided by the institution, an appropriate operational and legal structure that allows for the intra-firm transfer of equity, enforceability and implementation of bail-in in foreign jurisdictions, and powers, funding arrangements especially in cross-border, etc.

**4.138 To improve resolvability of financial conglomerates, the Group recommends that the financial holding company structure<sup>1</sup> may be introduced for Indian financial system. The appropriate method for resolving such institutions could be decided at a later stage as policy evolves and taking into account international developments. (Recommendation 26)**

#### ***Information requirements***

**4.139** Production and maintenance of resolution plans requires great deal of information and advance planning. Resolution is an invasive form of surgery of the financial institutions, thus making it even more important that suitable arrangements and systems are in place for submission of information to the resolution authority. Up-to-date information on the business operations, structures and critical economic functions of financial institutions serves as the basic raw material for the resolution authority to make appropriate decisions and implement an effective resolution action plan when resolution is imminent. The detailed information would enable the resolution authority to form opinions on the resolvability as well as choose among the tools that would be suitable for each financial institution. This will also be an important component for carrying out resolvability assessments of the financial institutions.

**4.140** The type of information the resolution authority would require in order to make an informed decision about the choice of resolution method includes the legal structure of the financial group, mapping of its principal businesses against that legal structure and identification of financial and operational dependencies among various elements of the group (*such as core business operations and interconnectedness by reference to business lines, legal entities and jurisdictions; intra-group exposures through intra-group guarantees*

---

<sup>1</sup>This structure has already been proposed as one of the important criteria for licensing of new private sector banks.

*and loans, and trades booked on a back-to-back basis; dependencies of the firm's legal entities on other group entities for liquidity or capital support).* It also includes the information concerning the bank's membership in payments, clearing and settlement infrastructures, information concerning the segregation of client assets and the procedures by which such segregated client assets could be transferred to third parties at short notice, and information on dealing room operations including trade booking practices, hedging strategies and custody of assets, etc.

**4.141** In order to assess the potential impact of disorderly wind-down or resolution of a financial institution on other institutions, markets and infrastructures, the resolution authority will also need information on the inter-linkages within and between financial institutions, on both sides of the balance sheet.

**4.142** Finally, the authorities would need information concerning the bank's deposit base – what is insured and what is not, as well as the maturity structure, terms and conditions of the deposits. The authorities need to know whether the deposit guarantee schemes in which the troubled bank is a member would be in a position to pay out insured depositors promptly in the event of failure. Moreover, in case of cross-border firms, the authorities would need additional information on the legal and regulatory frameworks in which the financial institution operates. This could include information on the relevant home and host authorities and their roles, functions and responsibilities in financial crisis management; the relevant aspects of applicable corporate, commercial, insolvency and securities laws and insolvency regimes affecting major portions of the group; and liquidity sources.

**4.143 With a view to enabling the FRA to make appropriate decisions and implement an effective resolution action plan, the Group suggests an indicative template that would facilitate financial institutions furnishing information relating to their structure to the concerned regulators/supervisors, who in turn can cooperate and coordinate with the FRA in finalization of resolution plan by FRA. (Recommendation 27)** An indicative template for RRP that includes parameters such as, organizational/financial group structure, capital structure and shareholding pattern, funding of entities, financial interconnectedness (inter and intra financial assets and liabilities), critical functions in each legal entity, etc. is given in **Annex 6**.

**4.144** While the above suggested data template would help the FRA to prepare effective and credible resolution plans for individual institutions, there is a need for real time financial

data in the hands of the authority responsible for financial stability. The recent financial crisis has revealed important gaps in data collection and systemic analysis of institutions and markets. Remedies to fill those gaps are critical for monitoring systemic risk and for enhanced supervision of systemically important financial institutions, which are in turn necessary to reduce the chances of such a serious crisis occurring in the future.

**4.145 The Group recommends setting up of an integrated financial database management centre, which would function as a centralized database wherein all financial institutions and FMIs will submit regular financial information electronically. The database will also capture the information/ database currently being collected/managed by the respective regulators. In order to ensure availability of high-quality and timely data (as high frequency as possible), the supervisory agencies and FRA should have access to the integrated financial database in respect of the data that they are authorized to collect from the regulated financial institutions. (Recommendation 28)**

#### *Functioning of service level agreements*

**4.146** Another important obstacle in sound resolution strategy is the need to continue the functioning of service level agreements in times of stress as well as after exercise of resolution option. In many financial institutions, for reasons of efficiency and economies of scale, operational functions such as trade settlements, custody of securities, payment operations, information technology and many other financial services are outsourced. The service provider could be either a separate legal entity within the financial institution, or a third-party. While outsourcing arrangements could bring about benefits in normal times, they may unnecessarily complicate resolution if the preconditions are not put in place to ensure continuity of the services in a resolution. There is, therefore, a need to continue the functioning of service level agreements in times of stress as well as after exercise of resolution option.

**4.147** In order to ensure continuity of essential functions in a resolution, for example, for the parts of a financial institution transferred to a bridge institution or surviving parts of a resolved institution, the Group recommends that key service level agreements should be legally enforceable in crisis situations and also in resolution. This is, however, feasible only through ensuring continuity of payment on the terms already agreed upon. In such cases, FRA would have to be duly empowered to ensure that the payments to the service providers continue to be un-affected during

resolution or there are powers in place to ensure that the payments to service providers rank higher in the hierarchy of creditors/ payments to be made by the FRA. *(Recommendation 29)*

## **Safeguards under Financial Resolution Framework**

**4.148** Use of various resolution tools coupled with associated resolution powers in order to resolve the failed financial institutions could potentially have significant adverse implications as well as negative effects for the shareholders and creditors as well as counterparties of the concerned financial institution. The power of the resolution authority to transfer all or part of the assets of a financial institution to another entity (through purchase and assumption tool, the bridge institution tool or good-bank bad-bank tool) interferes with the property rights of shareholders as these resolution actions would be effected without the consent of the shareholders that are normally required in a pre-insolvency phase. It is, therefore, important to ensure that a financial resolution framework prescribes appropriate protections and safeguards for the affected creditors and counterparties on one hand and also for the resolution authority initiating resolution actions in good faith. Therefore, safeguards need to be built in the legal framework in order to protect the interest of shareholders and creditors if large-scale intrusive measures are effected in financial institutions.

### ***Set-off rights, contractual netting and collateralization agreements and segregation of client assets***

**4.149** Generally, the netting or set-off rules operate under two modes – those that apply in the course of ordinary business among solvent counterparties termed as payment netting or settlement netting or delivery netting, and those that apply in resolutions of insolvent firms termed as close-out netting or default netting or open contract netting or replacement contract netting. Set-off, essentially the same as netting, takes place during the normal business of a solvent firm, and involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable. The concept of set-off applies only to parties with market debts of the same kind that are already due and payable, and that are legally distinct.

**4.150** Close-out netting applies to transactions between a defaulting firm and non-defaulting firm. It refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable. It generally involves three steps: termination, valuation and determination of net balance. Termination means that the non-defaulting party

puts an end to the obligations under the Agreement. Then valuation is done by determining the replacement cost of each transaction under the contract. Finally, the net balance, i.e. final net amount, is determined after netting the positive values (those owed to the non-defaulting party) and negative values (those owed by the non-defaulting party) under the single agreement. However, in case the defaulting party owes the close-out amount to the non-defaulting party, the non-defaulting party can apply the value of collateral posted by the defaulting party to the net obligation; and collateral in excess of the net obligation must be returned to the insolvency administrator. On the other hand, if the non-defaulting party owes the close-out amount to the defaulting party, it may set-off the amount that it owes against the amount owed to it by the defaulting party under other non-derivative contracts. The non-defaulting party will pay to the insolvency administrator any net close-out amount remaining after the set-off.

**4.151** While there are significant benefits of legally enforcing set-off rights, contractual netting and collateralisation agreements, there are some disadvantages also. The consensus of market participants and their regulators has been that the special characteristics of derivative markets justify legal protection of close-out netting of derivative contracts. Enforceable netting (and collateral) provisions are a major contributor to the large size and substantial liquidity of derivative contracts. Since financial institutions are required to hold capital against their risk exposures for regulatory, prudential and/or market disciplinary reasons, the need to hold capital against net rather than gross exposures will incentivise institutions to take larger positions on a given capital base. In addition, netting and related collateral agreements are one of the primary tools of risk management in the financial markets and have the effect of reducing the credit risk exposures as well as market risks of derivative market participants. Netting also enables the counterparties the ability to transfer and manage specific market risks more efficiently, while minimising their exposures to counterparty credit risk. Derivatives are potential sources of systemic risk and netting ameliorates this risk.

**4.152** On the other hand, this has also raised concerns that enforceable netting and collateral agreements might reduce the incentives of derivatives market participants to monitor counterparty risk-taking and to influence counterparties to limit their risk taking appropriately.

**4.153** It is also a fact that if close-out netting is not enforceable, market participants would need to assume the gross exposure and thus a probability of higher counterparty risk,

significant increase in capital requirements and requirement for more collaterals. Another effect would be the inability to adjust market risk positions and thus lead to difficulty in trading or managing risk with certainty. Market participants, as well as clearing houses, would face substantial uncontrollable risks because they could neither replace nor unwind the defaulted transactions with certainty. Moreover, the market participants may cut back or terminate transactions with troubled counterparties earlier than would be the case with netting. In such scenario, it will be difficult to manage the financial difficulties of troubled firms, which would lead to an increase in overall insolvencies and a systemic crisis.

**4.154** Netting and collateral facilitate the rebalancing process of exposures, netting by reducing the exposure that needs to be rebalanced and collateral by providing resources that can be off-set against replacement costs. Inability to terminate or net contracts with an insolvent firm would leave surviving firms vulnerable to losses caused by sudden market changes. Moreover, changing the treatment of derivative and other financial contracts would represent a major departure from the trend towards cross-border convergence of the treatment of derivatives and other financial contracts in insolvency and from the widespread acknowledgement by policy makers of the contribution of netting to financial stability.

**4.155** The crisis has revealed that, while the derivatives transactions entered into by large financial institutions can provide significant benefits, those activities on the same time could also be the source of significant risks. Thus, the importance of risk reduction and improved functioning of the financial markets for effective crisis management and resolution of cross-border financial institutions is being discussed internationally. Much progress has already been made in achieving legal certainty for close-out netting of financial contracts and collateral arrangements and legal reforms have successfully been adopted in most major jurisdictions, especially for the termination, liquidation and close-out netting of OTC bilateral financial contracts upon an event of default. As per the International Swaps and Derivatives Association (ISDA), 40 jurisdictions<sup>1</sup> have enacted legislations that provide for enforceability of close-out netting. The international setting bodies (more recently FSB and Cross-border Bank Resolution Group of BCBS) have strongly encouraged the use of such close-out netting provisions (alongside collateral) because of their beneficial effects on the stability of the financial system.

---

<sup>1</sup>Andorra, Anguilla, Australia, Austria, Belgium, Brazil, British Virgin Islands, Canada, Columbia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mauritius, Mexico, New Zealand, Norway, Peru, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, UK and US.

**4.156** While the Indian Contract Act, 1872 provides legal framework for bilateral netting, including close-out netting, the Companies Act, 1956 and Insolvency Acts of 1909 and 1920 only provide for set-off in liquidation where any financial company is involved. There are no legal provisions for other banks (i.e. public sector banks and RRBs) that are statutory corporations and co-operative banks. However, the Payment and Settlement Systems (PSS) Act, 2007 provides legal certainty, even in case of resolution, to multilateral netting arrangements in case of clearing/settlement services, that has become final and irrevocable. It also provides for overrides on the Companies Act, 1956, BR Act, 1949 and all other Acts in the case of insolvency of a system participant. However, arrangements not governed by the provisions of PSS Act, 2007 do not get the benefit of multilateral netting arrangements.

**4.157** The Supreme Court of India has held, in the case of Official Liquidator of High Court of Karnataka v. Smt. V. Lakshmikutty, AIR 1981 SC 1483, that whenever any creditor seeks to prove his debt against the company in liquidation, the amount that is ultimately found due from him at the foot of the account in respect of mutual dealings should be recoverable from him and not that the amount due from him should be recovered fully while the amount due to him from the company in liquidation should rank in payment after the preferential claims provided under company law are made. The same principle of set off and bilateral netting will apply in case a banking company goes into liquidation. It is not unambiguously clear whether the said principle of bilateral netting laid down by the Supreme Court will apply in respect of public sector banks if they are placed in liquidation by an order of Central Government as the said order may provide otherwise. There are no specific provisions for close-out netting in the extant legal framework, except (in the event of insolvency or so) for transactions admitted for settlement by a system provider<sup>1</sup>.

**4.158** As regards banks created under special statutes, the winding up/liquidation would be governed by their respective statutes. These statutes generally provide that those banks will not be wound up except by an order of the central government and in such manner as it may direct. The central government has not, so far, exercised this option and the government's stand in respect of set off of mutual claims, including close-out netting of contracts, will depend upon the manner in which liquidation is directed by the central government.

---

<sup>1</sup>Section 2(1)(e) of Payment and settlement systems (PSS) Act, 2007 - "'netting' means the determination by the system provider of the amount of money or securities, due or payable or deliverable, as a result of setting off or adjusting, the payment obligations or delivery obligations among the system participants, including the claims and obligations arising out of the termination by the system provider, on the insolvency or dissolution or winding up of any system participant or such other circumstances as the system provider may specify in its rules or regulations or bye-laws (by whatever name called), of the transactions admitted for settlement at a future date so that only a net claim be demanded or a net obligation be owned;" (Emphasis added regarding close out netting though the expression close out netting is not used in the section.)

**4.159** As regards segregation of client assets by the financial institutions, though there are regulatory guidelines in place for commercial banks to necessarily maintain client wise account/record of funds accepted and investments made there against, there are no legal framework in place that provides transparency and certainty.

**4.160** The Group considered that the extant legal framework, not being uniform for all financial institutions and not providing specific provisions, lacks in clarity and transparency and falls short of the provisions contained in the FSB Key Attributes. **In order to have systems in place that reduce systemic risk and costs for the institutions, increase liquidity in the financial market as a whole, and facilitate resolution of individual financial institutions, the proposed financial resolution framework or the existing statutes governing the financial institutions and FMIs should explicitly provide for rules, laws and practices governing enforceability of contractual set-off, close-out netting and collateral arrangements, and segregation of client assets. The legal framework should be clear, transparent and enforceable to facilitate the effective implementation of resolution measures. (Recommendation 30)**

#### *Stays on early termination rights<sup>1</sup> upon entry into resolution*

**4.161** Under the normal market agreements for financial contracts, such as ISDA master agreement, upon occurrence of an event of default, the non-defaulting party has the contractual and legal right to terminate the contract subject to the netting agreement. However, in case of initiation of formal resolution or insolvency procedures by the resolution authority for a failing bank, the contractual acceleration, termination and other close-out rights (collectively termed as “early termination rights”) may be triggered in financial contracts. In the case of a SIFI, the termination of large volume of financial contracts could result in a disorderly rush for the exits and destabilize the markets and impose significant costs on the institution in resolution and even hamper the implementation of resolution measures. This may have the potential to create systemic instability. In these circumstances, financial stability may be better protected by transferring the debtor’s financial contracts to a solvent third party or a bridge bank through resolution procedures.

**4.162** Though close-out netting provisions are effective as a risk mitigation tool, in times of financial stress, the enforceability of close-out netting provision might increase the risk that counterparties of a distressed financial institution rush to exercise termination rights and

---

<sup>1</sup>Generally, early termination rights relate to the ability of one party to terminate a contract upon the occurrence of specific events, which relate to default and creditworthiness.



close out their positions, thereby exacerbating systemic risk. Hence, it is important to ensure that in the event a financial institution has been put under resolution by the resolution authority, it should not trigger set-off rights, or constitute an event that entitles any counterparty of the institution in resolution to exercise contractual acceleration or early termination rights.

**4.163** While recognizing the usefulness of close-out netting in general, there is a need for a brief stay on the netting mechanism in situation in the context of resolution framework for financial institutions, so as to allow the resolution authority the time needed to decide whether and how to resolve an ailing financial institution in an orderly fashion so as to mitigate risk to financial stability. It is emphasized in the Key Attributes that the temporary delay should be kept as short as possible. It has been observed that delays for longer days unnecessarily expose the market participants to market risks, especially if a failure were to occur during a period of market instability<sup>1</sup>.

**4.164** The Group recommends that in order to allow time to FRA to decide a resolution action, the FRA should have clearly defined legal powers to impose a brief stay on the exercise of early termination and netting rights only in situation of entry of a firm into resolution. In order to contain the adverse impact on market of such a stay, the stay should generally be limited to two days (48 hours), which however could be extendable by a maximum of another three days after specifying the reasons in writing by the FRA. The FRA should not have any options to cherry-pick individual contracts with the same counterparty for effecting transfer. Further, following the transfer of financial contracts, the early termination rights of the counterparty should be preserved against the acquiring entity (transferee) in respect of subsequent independent default by the transferee. It should also be ensured that the substantive obligations under the financial contracts, including payment and delivery obligations, and provision of collateral, continue to be performed. (*Recommendation 31*)

**4.165** The Group also recommends that the FRA should not be allowed to transfer those assets that have a claim of secured creditors. It implies that, for example, in case of a bank or its counterparty having a security interest over an asset that

---

<sup>1</sup> A delay of 5 days would subject non-defaulting parties to up to 5 days of market exposure. Had such a delay occurred in November 2008, when the 10 year US dollar interest rate swap rate fell from 4.07% to 3.14% over a 5 day period, the credit exposure on \$1 billion of 10-year interest rate swap would have increased by \$77.3 billion. Thus, if the counterparty to these swaps were to default at this time, the non-defaulting party could have faced additional losses of up to \$77.3 billion.

**secures a liability owed to it by the other party, the charged asset may not be split up from this liability under a partial transfer. This would mean that the secured creditors' claims cannot be separated from the assets securing the liabilities in a partial property transfer (*Recommendation 32*)**

### ***Respect of creditor hierarchy***

**4.166** An important feature of effective resolution framework is to make it possible to impose losses on shareholders and unsecured and uninsured creditors in their order of seniority. It is also considered that resolution framework should promote market discipline by imposing losses on shareholders, subordinated debt holders, and if appropriate other creditors and counterparties of the financial institution, while providing safeguards for secured and other senior creditors, and protection of capital market transactions, such as securitization structures and covered bond programmes.

**4.167** Under the Indian Company Law, there are certain provisions providing for certain types of preferential payments. Similarly, Section 43A of the Banking Regulation Act, 1949 also provides for preferential payments to depositors, though in a limited way. Though the regulatory guidelines on capital adequacy, specifying the terms and conditions of regulatory capital instruments of financial institutions, especially banks and insurance companies, provide for seniority of claims in liquidation, it may, however, not provide legal certainty. Clarity and predictability in respect of the order of seniority or statutory ranking of claims in insolvency determines the allocation of losses and shapes the incentives of market participants and pricing of risk.

**4.168** Drawing from practices followed by other jurisdictions, a typical example of claims in bank bankruptcy would rank the creditors in the following manner:

- (i) Employee compensation, taxes and social contributions;
- (ii) Receivership operational expenses and administrative costs (all costs pertaining to the liquidation process), including other obligations created during Conservatorship or liquidation;
- (iii) Claims by secured creditors, up to the value of their security;
- (iv) Claims by insured depositors, or the subrogated claims of a deposit insurance agency (in cases where a deposit insurance scheme exists);

- (v) Claims by uninsured depositors<sup>1</sup> and other creditors;
- (vi) Claims by subordinated debt holders;
- (vii) Claims by shareholders.

**4.169** In certain situations, the deviation from general hierarchy of claims may be allowed. The Dodd-Frank Act reaffirms the principle that all claimants that are similarly situated should be treated in a similar manner. However, the FDIC can exceptionally differentiate between creditors within the same class, if it determines that it is necessary to maximize the value or minimize losses upon the sale or other disposition of assets or deemed essential to implementation of the receivership or any bridge financial company.

**4.170** With a view to fair distribution of assets from assets recovered from a failed institution, the Group recommends that:

- (i) the allocation of losses in the times of bankruptcy or application of resolution tools or use of any resolution powers should clearly be defined in the statute for financial resolution framework;
- (ii) the highest ranking creditors should be repaid first and the lower priority ones should be repaid only after all the senior creditors have been paid, thus respecting the hierarchy of claims (this implies that the equity should absorb the losses first, and then the subordinated debt holders, including all regulatory capital instruments in terms of seniority, and finally to the senior debt holders);
- (iii) the FRA may be provided flexibility to depart from the general principle of equal treatment of creditors of the same class, for example in case of bridge institution with limited assets or in use of bail-in authority, only in exceptional circumstances and by giving sufficient reasons. (*Recommendation 33*)

### ***Depositor preference***

**4.171** The Group considered the issue of 'depositor preference' in insolvency. The retail depositors are generally not well placed as other senior creditors to monitor banks' risk taking. The general adoption of depositor preference could help in avoiding losses to the retail depositors. While increasing the loss-absorbing load on non-deposit liabilities and placing greater responsibility on senior unsecured creditors, depositor preference would add

---

<sup>1</sup> Some jurisdictions, with or without a deposit insurance agency, may have depositor preference; that is, all depositors' claims (even uninsured, as applicable) have a higher claim priority than any other creditor.

a layer of protection for the uninsured depositors by allowing them to recover their claims before the lower ranking creditors. Depositor preference would also facilitate the implementation of resolution measures, such as a partial transfer or use of a good bank/bad bank approach, by making it easier to transfer all deposits to another entity or bridge bank while leaving the non-preferred debt behind.

**4.172** On the other hand, depositor preference also has drawbacks. The introduction of depositor preference may cause non-deposit funds to become more expensive relative to deposits. Further, the institutions may reduce their funding in non-deposit markets. The senior unsecured creditors might also reduce the average maturity of their claims. This would then make a 'run' on the depository institution more likely if its condition deteriorated.

**4.173** In the absence of depositor preference, the senior unsecured creditors are ranked pari-passu with the uninsured depositors and are given the same treatment in insolvency. Several jurisdictions like Australia, China, United States, Switzerland and Hong Kong, provide preference to depositors over other creditors in insolvency. However, in Switzerland and Hong Kong the preferred amount is limited to the insured amount, which enables the deposit insurance fund to recover compensation paid to depositors with priority. In India, the liquidator/transferee bank is required to repay to the DICGC on a preferential basis, out of the amount recovered from the assets of the bank in liquidation/ transferor bank.

**4.174** The Group considered that granting priority status to the claims of uninsured depositors in the winding-up of failed financial institutions would send clear signal that bondholders and other creditors are subordinated to depositors in liquidation proceeds of banks' assets to mitigate their losses. In case of insurance policyholders, the assets supporting the policyholders' funds cannot be utilized for any purpose other than to meet the policy liabilities as and when they fall due. These assets would be transferred in case of a resolution either to the acquirer in the event of a portfolio transfer or would support the run-off.

**4.175** The deposit insurance system operated in India by the DICGC provides for payment to the eligible depositors of insured banks located in India, including the foreign bank branches located in India up to the maximum limit of Rs.100,000. The depositor protection/ insurance is not provided to depositors of foreign branches of Indian banks by DICGC. However, in terms of Section 21(2) of DICGC Act, 1961, DICGC has a first claim on bank's liquidated assets up to the amount paid to the depositors. Since the depositors of foreign

branches of Indian banks are not insured by DICGC, and further that the DICGC has a first claim on bank's liquidated assets, the framework indirectly provides for a preferential treatment to the depositors of bank branches in India as compared to the depositors of branches of Indian banks situated in other countries. Such a provision in the DICGC Act, 1961 falls within the purview of the 'national depositor preference framework', and as such the depositors of foreign branches of Indian incorporated banks would not be treated at par with the domestic depositors.

**4.176** Such framework will also have an impact on deposit guarantee schemes (DGS) and the extent to which the institutions handling the DGS can recover funds in a resolution. If the home jurisdiction has an insured depositor preference up to \$100 and the host jurisdiction has an insured depositor preference up to \$200, then preferring deposits only up to the \$100 level in a whole bank resolution under the home jurisdiction's resolution framework would leave the host DGS worse off than in the case of a local host proceedings, as the host DGS would have to compensate depositors up to the amount of \$200 in its jurisdiction but would have preferred claims of only \$100 in the home jurisdiction proceedings.

**4.177 The Group recommends that as the ultimate objective of regulation and supervision in India is to protect the interests of depositors, insurance policyholders, and investors, the proposed statute for financial resolution framework should explicitly provide for preference to be given to depositors, insurance policyholders and investors over other unsecured creditors in resolution of failed financial institutions. (Recommendation 34)**

**4.178 Equal treatment may be provided to uninsured depositors of banks and claims of DICGC on account of payments made to insured depositors. This would require that the claims of DICGC rank pari-passu with other uninsured depositors in sharing the distribution of proceeds of liquidated assets of a failed bank. (Recommendation 35)**

#### ***Compensation safeguards and legal remedies***

**4.179** It is likely that while activating the resolution action and adopting certain resolution tool, especially the partial transfer to a bridge institution or to a private sector purchaser or good-bank & bad-bank method, to orderly resolve a non-viable financial institution, the value of the assets transferred are greater than the value of the liabilities transferred. This is done to ensure solvency and recapitalization of the new entity, in whatever form. This leads to

clear benefit to the depositors and other creditors whose claims are transferred to the new entity. They are able to continue as depositors of new institution with all of their transferred funds intact and with little or no disruption in their access to banking services. Similarly, the counterparties of the failed financial institution whose contracts are transferred to the new institution are able to carry on as before without having the need to deal with the consequences of insolvency.

**4.180** While recognizing that the affected parties in resolution need to have a right to compensation, it is important that such a right does not come in the way of resolution action. It is necessary that the resolution authority has the capacity to exercise the resolution powers with the necessary speed and flexibility, subject to constitutionally protected legal remedies and due process.

**4.181** *The FSLRC has recommended compensation arrangements in place enabling the resolution corporation to carry out the proceedings where persons or institutions need to be compensated as a result of resolution actions. The Commission also specified that the claimants would have the right under statute to appeal to the Appellate Tribunal for award of compensation by the resolution corporation.*

**4.182** The 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 (meaning resolution action cannot be reversed) 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 resolution framework may also provide a suitable mechanism for appeals and grievance redressal for affected stakeholders. *(Recommendation 36)*

### Different Stages of Bank Recovery and Resolution

Bank liquid, sound, solvent, and in compliance with prudential regulatory requirements	Bank reaching stage 3 of PCA framework	Bank becoming insolvent and breaching Stage 4 of PCA framework
<p>Intrusive supervision</p> <p>Preparation of Recovery Plan by the bank management</p> <p>Approval of Recovery Plan by Regulator/Supervisor</p> <p>Preparation of Resolution Plan by FRA</p>	<p>Bank put under close watch and radical restructuring</p> <p>Activation of Recovery options under Recovery Plan</p> <p>Placed under moratorium and merger and amalgamation with healthier bank</p>	<p>FRA takes complete control of the bank.</p> <p>1<sup>st</sup> option – Ordinary liquidation (if the bank does not provide any critical financial services and functions)</p> <p>2<sup>nd</sup> option – Recovery measures → Debt write-down or conversion into equity</p> <p>3<sup>rd</sup> option – Stabilization tools</p> <pre> graph TD     A[3<sup>rd</sup> option - Stabilization tools] --&gt; B[Debt write-down or conversion into equity]     A --&gt; C[Purchase and Assumption tool - Sale of whole or part to private sector purchaser]     A --&gt; D[Bridge bank tool]     A --&gt; E[Good-bank and bad-bank tool]     C --&gt; C1[Sale of whole or part to private sector purchaser]     D --&gt; D1[Sale of bridge bank to private sector purchaser]     E --&gt; F([Good Bank])     E --&gt; G([Bad])     F --&gt; F1[Sale to private sector]     G --&gt; G1[Liquidation or toxic assets given to asset management vehicle]     </pre>
Preparation and Prevention measures by regulator/supervisor	Early Intervention by regulator/supervisor	Resolution by FRA