EXECUTIVE SUMMARY

The global financial crisis, which began in 2007, forced countries to adopt ad hoc policies to stem the collapse of the financial system. Faced with lack of adequate resolution tools, countries turned to large-scale government support and bailouts of the financial institutions to preserve financial stability. The bailouts highlighted the shortcomings in the resolution mechanism of many jurisdictions, including inadequate powers and tools for resolving both bank and non-bank financial institutions, especially large and complex ones with cross-border presence. They resulted in very large increases in exposures for the public sector, equivalent to about one quarter of world GDP, and distorted financial markets.

In order to address the situation, many jurisdictions sought to improve national regulatory and supervisory frameworks and to develop more effective and less disruptive resolution frameworks for addressing failures of systemically important financial institutions (SIFIs) in a manner that minimises spillover impact on the real economy. A critical aspect of these far reaching legislative changes is the protection of taxpayers from exposure to losses and containing the negative externalities posed by too-big-to-fail (TBTF) institutions.

Following the crisis, the international standard setting bodies such as the Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), International Organization of Securities Commission (IOSCO), Committee on Payment and Settlement Systems (CPSS) have been developing policy proposals to address the moral hazard risks posed by the SIFIs. One of the important regulatory reform is the "Key Attributes of Effective Resolution Regimes for Financial Institutions", which set out the core elements for the resolution of financial institutions while limiting taxpayers' exposure to loss and protecting vital economic functions. The Key Attributes are being complemented by formulation of further supporting guidance for the resolution of non-bank financial institutions, including insurance companies and financial market infrastructures (FMIs). The FSB member jurisdictions are expected to bring their resolution regimes in line with the Key Attributes by end-2015.

Following the lessons learnt from the financial crisis and the need to have an effective and credible resolution framework for distressed financial institutions in India, the Reserve Bank of India constituted, as decided by the sub-Committee of the Financial Stability and Development Council (FSDC), a high level Working Group to suggest extensive strengthening of the resolution regime taking into consideration the structure of Indian financial institutions.

The Group began by acknowledging the importance of having a special or separate resolution framework for financial institutions from the corporate insolvency regime for such institutions. The financial institutions and FMIs are special because of their close interconnectedness and because they operate on the basis of public trust and confidence. This means that once problems develop in one institution, they can quickly spread to other sound institutions. The loss of private confidence can, in turn, create a domino effect, spreading contagion. A special resolution framework is needed because the general corporate bankruptcy or insolvency procedures cannot ensure sufficient speed of intervention or the continuation of the critical functions, thus undermining financial stability.

While India has a history of very few failures of financial institutions, the financial sector is growing in depth and complexity. Effective regulation and supervision, one of the pillars of safety net framework, can help in substantially reducing the risks but cannot make the financial system immune from failure of a financial institution.

The existing resolution powers and options available with the regulators, adopted to deal with any problem financial institution, have several gaps in comparison with the Key Attributes. As a result, there is an urgent need to implement such a special resolution regime that provides a comprehensive framework for dealing with the failure of financial institutions so that if a crisis arose in a regulated financial institution or it were to fail, the Government, the regulators and supervisors, as well as the resolution authority have the powers needed to deal with the situation efficiently, swiftly and effectively in a manner that maintains the continuity of the critical functions and does not hamper the financial stability. The proposed financial resolution framework will require a separate legal framework that provides the necessary powers and tools to resolve all financial institutions and FMIs irrespective of ownership in place of the existing separate statutes governing various types of financial institutions.

The special resolution regime must extend to all financial institutions - banks and non-banks - and be robust enough to address failures of small and medium financial institutions as well as failures of large complex financial institutions. Moreover, the resolution regime should also extend to financial groups/conglomerates. Complex financial groups will pose increasing risks to financial stability as they grow and become embedded in the financial system. Resolution of such groups requires specialized tools where resolution is applied at the level of the group, especially the parent company, rather than at the level of each individual institution. The resolution authority would essentially require coverage of all financial institutions and FMIs within the ambit of resolution framework.

In order to function effectively, resolution regime must achieve certain economic objectives, i.e., avoid creating moral hazard; pursue financial stability and ensure continuity of critical financial services and functions; provide protection to the depositors, insurance policyholders and investors, where applicable and within limits; and avoid erosion of value and seek to minimise the resolution costs.

Resolution of a failed financial institution is a complex process that requires specialised skills and expertise. Prevention of contagion and preserving stability will require timely intervention and speedy implementation of resolution tools. The Group concluded that such a function is best implemented by a specialised institution, the Financial Resolution Authority (FRA). The FRA would be responsible for the resolution of all financial institutions, regardless of size or of sector. This FRA should be institutionally independent and an equal player with other safety net agencies. The kind of experience and expertise, even if limited, available with the Deposit Insurance and Credit Guarantee Corporation (DICGC) in dealing with failures of banks could be leveraged. 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.

The effective resolution framework ought to provide credible set of tools and associated powers to the resolution authority to deal with failures and capabilities to intervene sufficiently early and quickly in a failing institution. These tools include: 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. What is common across all these tools is each of the resolution paths will typically impose losses on the shareholders.

Bail-in is a statutory power that enables resolution authorities to convert existing creditors into shareholders, thus recapitalizing the failed institution. Bail-in effectively recapitalizes a failed institution, creating a new, solvent institution in its place with new shareholders. For example, bail in can be used in the case of a bridge bank or restructuring and sale of the original, failed institution. This tool is in contrast to such tools as purchase and assumption that sell performing assets and selected liabilities of a failed institution to another operating institution.

Use of bail-in as a resolution tool has initiated considerable debate internationally. There are various pros and cons to the use of this tool. While it would give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances, it could simultaneously raise the funding costs for institutions. Bail in could also cause contagion of financial distress in those cases where the senior debt instruments of a troubled institution are held by other financial institutions. Though the bail-in tool initially impinges on the benefits of unsecured creditors, which could have been the primary beneficiary in case of liquidation of the institution, it could create value by providing creditors with higher returns once bail-in succeeds in restoring the viability of the distressed institution. It is, however, important that this tool is invoked only in case of SIFIs because of its nature of imposing losses to even the senior unsecured creditors.

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 tool, however, needs to be handled with due care. It should be ensured that this tool is operated only as an interim measure and the ultimate objective should be to arrange for a permanent solution such as, sale or transfer or merger with a private sector purchaser.

While resolution action gets kicked in when the financial position of the institution has weakened substantially but still has positive net worth and all its equity has not been fully wiped out, the framework must be preceded by preventive measures and early intervention measures so as to identify the developing problems in these institutions and address them at an early stage. Putting in place a prompt corrective action (PCA) framework that incorporates graded triggers at pre-specified levels for taking early actions by the regulators is important for each of the financial sectors. It is only towards the final stage that the failing financial institution is turned over to the resolution authority.

Complemented with the early intervention mechanism, contingency planning by the financial institutions is equally important both for supervisors as well as the resolution authority. Part of contingency planning involves development of recovery plans developed by the institution and aimed at detailing in advance the early but credible options/actions that would be taken by the concerned financial institution to restore its long-term viability if the institution's financial situation deteriorated due to idiosyncratic and market-wide stress. In contrast, the resolution plan sets out in advance a feasible strategy and detailed roadmap with options for orderly resolution. The process of formulation of recovery and resolution plans in advance would give a clear picture of the feasibility of resolvability of the financial institution. It is important that at least the domestic SIFIs are brought within the framework.

For proper functioning of the resolution authority in achieving the objectives, constant consultation, cooperation and coordination among the regulators/supervisors and the FRA is important. This calls for strengthening the cooperation and consultation mechanism by entering into MoUs. In case of financial groups/conglomerates, constitution of a small and cohesive group for on-going recovery and resolution planning, coordination and information sharing could help to contain the systemic impact of the problems occurring in financial institutions.

All the key attributes as set out in the FSB document are not suitable for all sectors of financial system and during all circumstances as different types of financial institutions have distinct features. The legal framework that will evolve needs to take into account the specificities and peculiarities of different segments of the financial sectors.

In order to facilitate and support the implementation of Key Attributes across jurisdictions in a consistent manner, the FSB is in the process of developing wide-scale guidance and policies in various aspects of recovery and resolution planning for banks as well as standards for insurers and non-bank financial institutions including FMIs. The recommendations of the Group are based on the final guidance documents as well as the drafts of consultation documents published by the FSB and best international practices in this area. There would be need for a review of the recommendations made by this Group at an appropriate stage to take into account the documents and guidance as and when issued by FSB and other international standard setting bodies with respect to evolving areas, especially those relating to non-bank financial institutions including FMIs and cross-border issues.