A Note on FRDI Bill

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[***Abstract:*** *The bail-in Clause 52 of the FRDI Bill has come under debate, raising concerns about the safety of deposits in banks and the larger objective of the bill being lost sight of. The FRDI Bill seeks to establish a Resolution Corporation to monitor the health of financial firms so as to take timely rescue measures if they tend to be sick. The bail-in clause has sufficient safeguards to ensure that depositors' risks are not hiked with the enactment of the Bill.*]

Pre-1991, financial firms in India (banks, insurance, mutual funds, and pension) were mainly government-owned and the fear of failure was minimal. Also, there was no need for sector regulation. But as the market expanded in the post-1991 period to allow financial firms to come up in the private sector, sector regulators came forward to set up the oversight mechanism to monitor the behaviour of financial sector entities. As the market evolved, the behaviour of financial sector entities became more complex and interconnected. The 2008 financial crisis brought to the fore the perils of an interconnected financial system that could cause an entire system to crash due to the sudden failure of a firm. All over the world, governments have put in place "resolution" systems and processes for early warning against failure of financial firms. In the evolving financial sector in India, the Financial Resolution and Deposit Insurance (FRDI) Bill is a significant step.

The FRDI Bill seeks to put in place a Resolution Corporation (RC) to closely monitor the health of financial firms such as banks, insurance companies, stock exchanges and payment systems, with a view to catch early on symptoms of ill health rather than allow them to become more sick and suddenly come to the brink of failure and thus expose themselves to the risk of contagion. A Bankruptcy Regulator alone will not be sufficient to manage the case of financial firms such as banks and insurance

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companies that collect deposits and premiums from a large number of retail investors who may not be able to come together as creditors and initiate bankruptcy process. Further, in bankruptcy proceedings, the depositor and the insured will be the worst hit since failure of a bank and an insurance company will hurt them the most. Therefore, there is need of both an early warning system and a resolution system for financial firms.[1]

Hitherto, different regulators in the financial sector have their own ways of dealing with situations. Generally, stronger entities are leased to take over the failing entities in the respective subsectors. Also, the processes are ad hoc and there is no agency/mechanism to monitor and resolve the crisis in financial firms. It is in view of this that the FRDI has proposed the setting up of the RC to monitor the firms and resolve failures of service providers.

The proposed RC will be under the Ministry of Finance and its board will comprise independent directors and representatives from the financial sector regulatory bodies. The RC and sector regulators will put in place rules that will classify financial firms into five categories—low, moderate, material, imminent and critical risk to viability—based on their risk of failure. Risks will be evaluated on the metrics of capital adequacy, assets and liability, asset quality, capability of management, earnings sufficiency, leverage ratio, liquidity of firm, and so on.[2]

The FRDI Bill puts in place a process to monitor a firm that is classified as "material" or "imminent" risk to failure, giving time to the firm (and its system) to either recover from illness or to prepare for failure if it is edging towards the terminal stage.

If the firm gets classified as "critical" risk, then the RC would have several resolution methods. It can take over the administration of the entity on the day it is classified as "critical" and use any one or more of five routes to resolve the crisis. One, it can transfer assets and liabilities of the firm to another firm. Two, it can merge the

1 Halan, M. (2017), "FRDI Bill is Not Going to Hike the Risk to Your Deposits," *Livemint*, December 13.
2 *Ibid*.

firm or put it up for acquisition. Three, it can create a bridge financial firm to take over the assets, liabilities and management. Four, it can use the bail-in provision or convert the debt of the firm. Five, it can liquidate the firm.[3]

Thus, the FRDI is an instrument to devise a process of classifying financial firms according to the risk they face and when the risk becomes high, to put in place a rule-based system to resolve the crises. This is an institutional arrangement overcoming the ad hoc approach followed so far to deal with the failure of financial firms.

Recently, the bail-in Clause 52 of FRDI Bill has been extensively debated, resting upon the apprehension that if this clause is invoked to resolve the crisis of a financial institution, say a bank, then the depositors may lose their deposits. In a bail-in, the deposit, which is a liability or debt for the bank, can be written-off or be subject to a haircut or may change form. Will the depositors lose their money? The material position in respect of deposits is that it will not be in a state worse than what it is in at present. It may be in a better state. Before the enactment of the FRDI, each depositor enjoyed a maximum insurance of up to Rs 1 lakh through the Deposit Insurance and Credit Guarantee Corporation (DICGC). When the FRDI is enacted, the RC, in consultation with the RBI, will insure bank deposits and set the insurance limit, which in all likelihood will be in excess of the present limit of Rs 1 lakh that was fixed way back in 1993. Further, the bail-in can be invoked against an individual's deposit only if the individual has given his/her consent to the bank at the time of signing the terms of deposit. Also, it is politically impossible that the government will allow bank depositors to lose their money due to bank failure, even beyond insured amounts. The FRDI Bill does not envisage the removal of the bailout option, at least till the setting up of the RC. Besides, the option of entering into mergers with stronger financial firms will be available to the RC. Thus, the coming up of the RC should not be scoffed at because of the bail-in clause. Rather, it should be seen as an instrument for monitoring the health of financial firms in order to prevent them from becoming terminally ill.

[3] *Ibid*.