White Paper on

Financial Resolution and Deposit Insurance Bill, 2017

The Bail-in Clause

All India Professionals Congress,
Bangalore North Chapter & Bangalore Central 1
Karnataka

1. Background

As of 2017, the Non-Performing Assets (NPAs) of all Indian banks put together have crossed the value of Rs. 8 lakh crore. One of the primary ways of dealing with NPAs is to enhance the banks' equity capital. Maintaining adequate capital augments the bank's capacity to absorb losses and thus the focus of prudential banking norms has been on increasing the capital availability of the banks. Accordingly, the banks are mandated to follow BASEL norms, which require them to keep aside a certain percentage of capital – typically as a proportion of its 'risk-weighted' assets viz. loans. These are popularly known as capital-adequacy requirements in the banking literature.

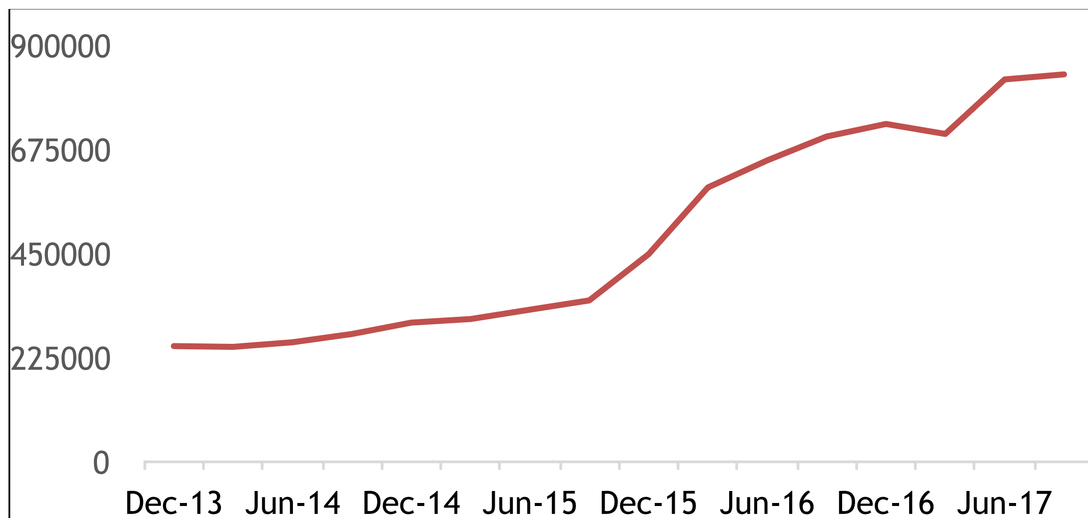

Figure 1: NPAs of all Scheduled Commercial Banks (RBI data)

Capital-adequacy can be attained in two ways: one is enhancing the capital and two, reducing the liabilities of the banks viz. its deposits. To address the issue of NPAs, the government has been acting pro-actively , to push through several fast-track measures.

The Re-capitalization bonds, proposed in November 2017, aim at enhancing the banks' capital by injecting capital worth 2.11 lakh crores into public sector banks. The other measure was the passing of the Bankruptcy Code Bill (Insolvency and Bankruptcy Code--IBC--reform), that facilitates the liquidation of manufacturing companies and thus makes the resolution of NPAs easier.

The other important measure that is currently under discussion of the Joint Parliamentary Committee, is the **Financial Resolution and Deposit Insurance (FRDI)** Bill. This Bill aims at meeting the capital-adequacy requirements by reducing banks' liabilities. This white paper discusses the proposed FRDI bill in detail.

2. Background and Clauses of FRDI Bill, 2017

Just as the Bankruptcy Code deals with the sick companies within the Manufacturing sector, the FRDI Bill is aimed at enhancing quick liquidation and restructuring of financial institutions that are on the verge of bankruptcy. The Bill proposes to create a Resolution Corporation, which will exercise control over banks, insurance companies, regional rural banks (RRBs), co-operative banks and other financial institutions. This corporation, once formed, will replace the erstwhile Deposit Insurance and Credit Guarantee Corporation of India.

The decision-making authority of the Resolution Corporation would rest with a board that would be headed by a chairman and comprise one member each representing the Finance Ministry, the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI), and the Pension Fund Regulatory and Development Authority (PFRDA). In summary, the board will have three full-time members; and two independent members to be appointed by the Government of India.

The Resolution Corporation will start with categorizing the financial institutions as "systemically important financial institutions (SIFI)". The criteria for designating an institution as a SIFI will be based on its size, complexity, nature and volume of transactions with other financial service providers, interconnectedness with other financial service providers and nature of services provided. Next, based on their imminent bankruptcy risk, each SIFI will be categorized into one of the five categories based on its risk of failure: low, moderate, material, imminent and critical risk to viability. Currently, among the banks, SBI, ICICI, HDFC, AXIS and Kotak Mahindra Bank have been classified as SIFI.

The board of the Resolution Corporation will have the power to order amalgamation, merger, liquidation and acquisition of any bank, including State Bank of India (SBI) and other nationalized banks, RRBs, cooperative banks and payment banks, and any insurance company, including Life Insurance Corporation of India (LIC) and other general insurance companies, if, in its judgment, the institution concerned (bank or insurance company) has got "imminent" or "critical" risk to its viability.

2.1.Supreme Powers vested in the Resolution Corporation

The primary issue of concern of the FRDI bill is that it attempts to place the entire financial infrastructure of the country at the mercy of the government. The Resolution Corporation has been given powers that override those vested in the RBI, the Central Vigilance Commission (CVC) and even the Central Bureau of Investigation (CBI). Moreover, the measures taken by the corporation cannot be challenged in any court of law, including the Supreme Court. The Bill categorically states that "an order for the winding up of a bank or an order sanctioning a scheme of compromise or arrangement or of amalgamation, or an order for the supersession of the committee of management or other managing body of a bank and the appointment of an administrator thereof made with the previous sanction in writing or on the requisition of the RBI or the corporation, as the case may be, shall not be liable to be called into question in any manner".

Besides, the Bill also proposes to amend the SBI Act by inserting a clause for its liquidation. This has given rise to wide-spread apprehensions that in due course the government might even take recourse to privatization of the SBI.

The bill also authorizes the Resolution Corporation, to hand over any institution with critical risk to another entity, public or private. It will be authorized to order discontinuation of service of employees or transfer of their employment or reduction of their remuneration upon such "resolution".

2.2.The Bail-In Clause

If the supreme authority vested in the Resolution Corporation is a cause for concern; the 'bail-in' clause in the bill that has the potential to dramatically impact retail depositors is rather grave. So, what exactly is implied by the term 'bail-in' and what ramifications does it entail for retail depositors?

We have often heard of the term 'bail-out', which has been the primary method of bailing out defunct banks using public money in the United States during the recession of 2008. While, 'bail-out' refers to the rescue of banks based on public funds (typically tax-payer money), 'bail-in' refers to rescue of banks based on customer deposits. Historically, several countries in the European Union have toyed

with the ‘bail-in’ clause in their bid to revive their banking system with dire consequences.

It has been largely believed that ‘bail-out’ encourages the problem popularly known as ‘moral hazard’ in the conventional economic literature. In simple terms, it implies that an assurance of a government ‘rescue’ in event of bankruptcy, takes away the incentive from banks to closely monitor the quality of its lending. Tax-payers, money is thus being sacrificed at the altar of risky behavior of banks.

The next relevant question is how will ‘bail-in’ address the moral hazard? The rationale here is that since bank deposits involve people’s personal funds, there exists a potential incentive for them to closely monitor the asset quality of banks, such that it prevents them from future ‘bail-in’ by the bank. The process of monitoring by retail depositors will be facilitated by the ratings assigned to each bank by the Resolution Corporation. Thus, the borrowers are expected to continuously monitor the health of their bank and move out their funds in event of an expected bankruptcy well in advance.

Having understood the meaning of ‘bail-in’ let us focus on what the FRDI Bill states regarding the bail-in clause. The bail-in clause listed in the bill provides the financial institutions the authority to **cancel the liability** or **modify or change** the nature of its liability. (Banks liabilities essentially refer to customer deposits).

2.2.1.Canceling the liability

Canceling the liability implies refusal on part of the bank to honor its commitment towards deposit repayments. E.g. If an individual has a deposit worth Rs. 15 lakh with a bank, and if the bank cancels the liability by activating the ‘bail-in’ clause; the customer will be eligible to only the portion of his deposits that are guaranteed by deposit insurance, which is currently capped at Rs.1 lakh, thus amounting to a straight loss of Rs. 14 lakh for the individual.

2.2.2.Modifying the liability

Modifying a liability would imply changing the terms of contract of the liability. This gives the bank the authority to convert the instrument from one form of liability to another or replace the instrument with another instrument of a different class or creating a new security of any form or class in connection with the modification of such instrument. E.g. a Savings Deposit account may be converted to a Fixed Deposit, a Fixed Deposit of tenure of 1 year may be converted to that of a five year or higher tenure or deposits may be possibly converted into long-term bonds or preference shares with no guarantee of dividend.

The bail-in clause covers all bank liabilities that are greater than the period of seven days, which basically imply all of savings and fixed deposits. Only the deposits that the bank owes to the center (viz. government) do not fall under the purview of the bail-in clause.

In addition, the ‘bail-in’ clause allows the bank ‘haircuts’ of collaterals or margins. A haircut would simply mean a reduction in the interest rate that needs to be paid to the depositors or it could possibly mean the reduction of the principal amount itself. E.g. For a deposit of Rs. 15 lakh for 5 years at an interest rate of 8%, the bank now has the authority to reduce the interest rate to anything lower, or reduce the principal payment by any amount. Thus, in the event of the bank declaring bankruptcy, the depositor will be eligible for just a cover of Rs.1 lakh of deposit insurance.

Interestingly, it must be noted that the magnitude of the deposit amount eligible for new deposit insurance coverage has not been specified anywhere in the bill.

3. Critical Questions to be raised

Given the draconian nature of the overriding authority given to the Resolution Corporation and especially the bail-in clause, the proponents of this bill need to answer a few critical questions:

3.1. What is the underlying rationale for 'Bail-in' and how logical is that?

The support for 'bail-in' comes from the rationale that 'bail-out' is essentially misuse of tax-payer resources. When banks know in advance that they will be bailed out by public resources viz. tax payer money, they can take intentional risks in making loans. To get over this classic problem of moral hazard, the depositors need to bear the risk of deposits that will provide an incentive to them to monitor the health of the banks. Thus, the bail-in provision would essentially safeguard tax payer money at the risk of depositor money.

However, the assumption here is that the depositors possess the time, inclination and intellectual resources to monitor the bank health and funds usage. It would be a leap of faith to make this assumption given the low financial literacy rates in India. Moreover, it is perhaps completely illogical to expect people in their health in 80s and 90s to monitor the health of banks!

Currently, about 99% of Indian households possess a bank account and about 66% of the formal sector savings in India are vested with banks. The FRDI bill in general and the 'Bail-in' clause in particular has a callous attitude to the savings habits of ordinary Indians For pensioners, housewives and first-time entrants into the banking system – bank deposits are possibly the only savings instruments that are understood and trusted. For pensioners in particular, in absence of pension schemes, bank deposits are the most commonly used avenue for parking their lifetime savings. In fact most pensioners primarily live off the interest received on their bank deposits.

Moreover, in a country like India, with the formal insurance penetration rate of just 4%, bank deposits serve the purpose of not just savings but also insurance. In case of all contingencies – expected or unexpected – education, marriages, child birth, illnesses and death; bank deposits are the only reliable source of insurance. A possibility of depriving households of their hard-earned money amounts to nothing short of sheer cruelty.

3.2. Are there other Savings options for the Middle-Class?

The very preference for banks over other investment options stems from lack of awareness about other exotic financial products. The primary rationale for investing with banks is often safety, which makes bank depositors accept lower returns as compared to other asset classes. In fact, in a country, where the real interest rate on bank deposits is often negative; the prime purposes of saving in the form of bank deposits are 'security' and 'safety' alone.

The FRDI bill makes a conscious attempt to push people towards either stock markets or other informal savings sources with higher risks. Given that currently only 8% of the urban and 0.5% of the rural households participate in stock market investments; this push is likely to be more towards other informal savings avenues such as chit funds, where the risk of losing their hard-earned money is even higher.

3.3. Why should the depositors pay for bankers' mistakes?

The larger issue is – bad loans have not arisen out of the mistakes of retail depositors – so why the depositors should be expected to bear the brunt? In fact, it encourages a classic situation wherein there is no incentive on the part of banks to reduce bad loans as depositors' money can be dipped into in order to bail them out.

Realistically speaking, the NPAs could have possibly arisen due to various reasons. Some of them arise from genuine industrial sickness whereas a large section of them are from 'wilful' defaulters. In India, 50% of the NPAs of the Public-Sector Banks originate from just 12 business houses. In a country, which is known for the strong nexus between politicians, bankers and business houses; the possibility of collusion to advance large loans to willfully defaulting business houses, and in turn expecting the small depositors to bail them out can be looked upon as crony capitalism at its best.

The sheer assumption of expecting depositors to monitor banks' health and moving around their savings accordingly from 'high risk' to 'low risk' banks, precludes that the retail depositors are well-informed about the 'corrupt' bank deals. In India, given the huge variation in literacy rates and levels of financial understanding among depositors, there exists a huge information asymmetry with respect to the information available within the public domain itself. Under such circumstances, expecting an awareness about the banker-politician-corporate nexus and the underlying dealings therein and its impact on the banks' balance sheet is simply ridiculous to expect!

Moreover, the argument that tax-payer's money needs to be protected at the cost of depositors completely ignores the fact that depositors are tax payers themselves. After having diligently paid taxes on their incomes and bank interest, subjecting their deposits to corporations' 'greed-tax' under the bail-in clause is necessarily inhumane.

3.4.What about the depositor faith in banking system?

FRDI Bill, if it goes through will be the third whammy to hit the Indian citizens post the policy blunders of de-monetization and GST.

Thanks to the push provided by Pradhan Mantri Jan-Dhan Yojana (PMJDY) and de-monetization, as of 2017, about 99% of the households in India hold at least one bank account. A larger issue is the destruction of faith in the banking system itself. If the people cannot be assured withdrawal of their deposits in exigencies, it is likely to dent the very fabric of trust on which public sector banking has been built. Even a miniscule speculation regarding the risk to withdrawal of their deposits could in the extreme situation encourage a 'run' on banks.

3.5.Does the FRDI Bill go against the spirit of Financial Inclusion?

The rationale of financial inclusion has been to bring greater number of people under the purview of formal banking. The government claims to have made great strides in the arena of financial inclusion. The PMJDY, has been witness to the opening of nearly 29.6 crore accounts in the last three years, 17.7 crore of which are in rural areas and 11.9 crore in urban areas. The number of RuPay cards has increased to 22.7 crore. The amount of money in these accounts is Rs 65,900 crore, implying an average of Rs 2,234 in each account as compared to Rs 837 in January 2015.

However, the bail-in clause under the FRDI bill precisely goes against this spirit of financial inclusion. If people cannot be assured of withdrawal of their deposits, why would they save their money in banks to start with? It must not be forgotten that less than a year ago, de-monetization has already dented the trust in the banking system. Several surveys, including one conducted by the author in rural Karnataka during the post-demonetization period have revealed that there still exists a strong preference for savings via informal routes. Almost 100% of the rural households exhibited a preference for savings in the form of cash at home or with relatives.

The 'bail-in' clause if implemented would essentially imply a roll-back of the success attained so far in the realm of financial inclusion, by pushing savings back into the realm of the informal sector.

3.6. What will be the impact on Savings Rate and Private Investments?

Banks being the primary sources of savings, the 'bail-in' would possibly result in a sharp decline in the formal sector savings rates. This in turn has severe consequences for private investments. It must be noted that private investment as a proportion of GDP as of 2016-17 has been at an all-time low of 30%, a decline from that of 42% in 2007.

Retail bank deposits have been the primary formal funding sources of agricultural and small and medium enterprise investments. With an imminent risk to deposits, the policy makers would need to identify other potential sources of funds to the above sectors. Moreover, in India, the infrastructure has also been largely funded out of bank loans. This has been owing to the lack of development of the long-term bond markets. With a decline in deposits, the overall infrastructure investment too is likely to plummet.

3.7. What has been the experience of other countries?

Several countries have experimented with the 'bail-in' clause in the past. Most of these belong to the European Union – Cypress, Greece, Denmark, Portugal, Hungary and Italy. In almost each of these countries, depositors have had to forego their deposits with this percentage being as high as 50% for Greece and Cyprus.

Hence, despite the assurances of the finance minister about protection of depositor interests, still does not make it a correct policy initiative. Bail-in, if at all used needs to be in the context of large wholesale deposits on which a risk premium is paid, but clearly that is quite far from what has been proposed in the FRDI Bill.

4. Fundamental Right to 'Withdrawal of One's Money'

The Finance minister as of now has been trying to allay the fears stating that only private sector banks will be possibly subject to 'bail-in'. Currently, banks such as ICICI, HDFC and AXIS Bank have been classified under the high-risk category. However, these banks by themselves are likely to account for a significant proportion of middle-class savings. Moreover, given the possibility of privatization of public sector banks in the future, this argument of the finance minister seems hardly convincing.

The finance minister has further said that it is unlikely that the banks will 'cancel' the deposits but would rather convert them into bonds of 20 year maturity. Liquidity is the primary reason that makes bank deposits an attractive savings option. Converting it into a long-term bond simply completely destroys this liquidity feature. Moreover, what use is a 20 year bond to those who are in their 70s or 80s already?

The fundamental issue that needs to be addressed is that 'right to withdrawal' of one's money needs to be pushed as a fundamental right of every citizen. It is the absence of the same that makes it possible for implementation of policies such as demonetization or the proposed FRDI Bill.

5. Conclusion

Before presenting the FRDI bill in Parliament and making it a law, the Government of India and the finance ministry must consult the citizens and seek their opinions. It is also equally important to allay fears around cash withdrawal, bail-in norms and other key provisions in the bill. In the aftermath of ad-hoc policies such as demonetization and big defaulters fleeing the country or constantly restructuring their loans, people's trust on financial institutions has considerably eroded. To restore the trust on institutions and to avoid an eventual meltdown of the banking sector as a whole, the

government must take a step backwards and form a think tank with learned experts in the field come up with any reform related to banking and finance.