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# **Report of the Working Group on Resolution Regime for Financial Institutions**

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**Reserve Bank of India  
January 2014**

## LETTER OF TRANSMITTAL



Reserve Bank of India  
Central Office  
Shaheed Bhagat Singh Marg  
Mumbai



Government of India  
Ministry of Finance  
Department of Economic Affairs  
New Delhi

Dr. Raghuram Rajan  
Governor and Chairman of Sub-Committee of FSDC  
Reserve Bank of India  
Mumbai

January 18, 2014

Dear Sir,

### **Report of the Working Group on Resolution Regime for Financial Institutions**

We have great pleasure in submitting the Report of the Working Group on Resolution Regime for Financial Institutions, appointed vide Memorandum dated January 23, 2013.

2. The Working Group examined the issue by assessing the need of a Resolution Regime for all financial institutions so as to resolve problem/non-viable institutions in a manner that ensures continuity of critical services provided by them and thereby facilitates financial stability. This was achieved by reviewing the existing resolution powers and tools available with each of the financial sector regulators/supervisors and the central government and identifying the gaps vis-à-vis the FSB "Key Attributes", the global experiences and best practices followed by major jurisdictions. The Working Group has proposed wide reaching recommendations considering the nature and position of the financial institutions in India. The Working Group has considered that the proposed resolution regime would apply equally to all financial institutions and financial market infrastructures irrespective of ownership.

3. Considering that the Financial Stability Board is in the process of framing guidance on various aspects, especially application of Key Attributes to non-bank financial institutions, the FSDC may need to review the recommendations made by this Group at an appropriate stage.

4. We sincerely thank you for entrusting us with this responsibility.

With regards,

Yours sincerely,

(Anand Sinha)  
Chairperson

(Dr. Arvind Mayaram)  
Co-Chairperson



(Anand Sinha)  
Chairperson



(Dr. Arvind Mayaram)  
Co-Chairperson

(M. J. Joseph<sup>1</sup>)  
Member

(Ramesh Abhishek)  
Member



(P. Vijaya Bhaskar)  
Member



(B. Mahapatra)  
Member



(Jasbir Singh)  
Member



(Dr. C. S. Mohapatra)  
Member

(Alok Nigam<sup>2</sup>)  
Member




(P. K. Nagpal)  
Member



(Usha Suresh)  
Member



(G. S. Hegde)  
Member



(P. Vijaya Kumar)  
Member



(Vijay Chugh)  
Member



(Dr. Mamta Suri)  
Member



(Deepa Kotnis)  
Member



(Chandan Sinha)  
Member-Secretary

<sup>1</sup> Shri M. J. Joseph did not attend any of the meetings of the Working Group

<sup>2</sup> Shri Alok Nigam attended one meeting of the Working Group and has since been transferred from Department of Financial Services, Ministry of Finance, Government of India

# CONTENTS

<b>List of Abbreviations</b>		i - iii
<b>Executive Summary</b>		iv - viii
<b>Chapter 1</b>	<b>Introduction</b>	<b>1 – 9</b>
	Background	1
	Constitution of the Working Group	4
	Structure of the Report	8
	Acknowledgements	8
<b>Chapter 2</b>	<b>International Practices and Global Initiatives</b>	<b>10 – 32</b>
	Global financial crisis – Drawbacks and Shortcomings	10
	Need for an Effective Resolution Regime	16
	Reforms in Resolution Regimes	17
	Thematic Peer Review on Resolution Regimes across Jurisdictions	20
	Multilateral Global Initiatives	21
	FSB Work in Progress	27
<b>Chapter 3</b>	<b>Existing Resolution Regime for Indian Financial Institutions</b>	<b>33 – 71</b>
	Brief Overview of FSB Key Attributes	33
	Indian Financial System	37
	Regulatory Framework for Indian Financial System	38
	Financial Stability	41
	Legal Framework for Resolution of Financial Institutions	42
	Existing Resolution Regime and Assessed Gaps	42
<b>Chapter 4</b>	<b>Framework for Resolution of Financial Institutions</b>	<b>72 – 134</b>
	Preparedness for Dealing with Failures	74
	Need for Resolution Framework for Financial Institutions	76
	Objectives of Resolution Framework	80
	Scope of Financial Resolution Framework	82
	Constitution of Resolution Authority and its Role	86
	Triggers for Entry into Resolution	90
	Resolution Tools	96
	Funding of Resolution	107
	Preventive and Contingency Planning	113
	Safeguards under Financial Resolution Framework	123
<b>Chapter 5</b>	<b>Cross-border Cooperation, Coordination and Information Sharing</b>	<b>135 - 149</b>
	Challenges in Crisis Resolution	136
	Need for Cooperation and Coordination	140
	Access to Information and Information Sharing	144
	Constitution of Crisis Management Groups (CMGs) and Institution-specific cross-border cooperation Agreements (COAGs)	148
<b>Chapter 6</b>	<b>Way Forward</b>	<b>150</b>
<b>Chapter 7</b>	<b>Summary of Recommendations</b>	<b>151 - 162</b>
	<b>List of Annex</b>	<b>163 - 241</b>
	Annex 1 – Recent Legislative Reforms in Major FSB Jurisdictions	163
	Annex 2 – Thematic Peer Review on Resolution Regime: Highlights	190

		Annex 3 – Draft Annex to the FSB Key Attributes: Resolution of Insurers	197
		Annex 4 – Prompt Corrective Action (PCA) Framework	209
		Annex 5 – Recovery Plan - An Indicative Methodology for Banks	215
		Annex 6 – Data Template for Domestic Systemically Important Banks	235

## List of Abbreviations

AACS	As Applicable to Co-operative Societies	CPF	Customer Protection Fund
AMC	Asset Management Company	CPSS	Committee on Payment and Settlement Systems
AIG	American International Group	CRA	Central Recordkeeping Agency
BA	Banking Act, 2009	CRAR	Capital to Risk Weighted Assets Ratio
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht	CRCS	Central Registrar of Co-operative Societies
BCBS	Basel Committee on Banking Supervision	CSD	Central Securities Depository
BCCI	Bank of Credit and Commerce International (Overseas) Limited	CSE	Consolidated Supervised Entities
BENELUX	Belgium, Netherlands and Luxemburg	DBOD	Department of Banking Operations and Development
BIP	Bank Insolvency Procedure	DCA	Department of Company Affairs
BIS	Bank of International Settlements	DFIs	Development Financial Institutions
BoE	Bank of England	DGS	Deposit Guarantee Scheme
BR Act	Banking Regulation Act	DICGC	Deposit Insurance and Credit Guarantee Corporation
BSBL	The Benaras State Bank Limited	D-SIB	Domestic Systemically Important Bank
BSE	Bombay Stock Exchange	D-SIFI	Domestic Systemically Important Financial Institutions
CBRG	Cross-border Bank Resolution Group	EBA	European Banking Authority
CCIL	Clearing Corporation of India Limited	EEA	European Economic Area
CCP	Central Counter Party	EOI	Expression of Interest
CDIC	Canada Deposit Insurance Corporation	EU	European Union
CDS	Credit Default Swap	FATF	Financial Action Task Force
CDSL	Central Depository Services Limited	FC	Financial Conglomerate
CET1	Common Equity Tier 1	FDIC	Federal Deposit Insurance Corporation
CIMB	Centre International D'Etudes Monetaires Et Bancaires	FDMC	Financial Data Management Centre
CMG	Crisis Management Group	FMSA	Financial Market Stabilisation Authority
COAG	Cooperation Agreement	DGF	Deposit Guarantee Fund
CoCo	Contingent Convertible	FHC	Financial Holding Company
CPC	Civil Procedure Code	FIs	Financial Institutions

FINMA	Financial Market Supervisory Authority	KAs	Key Attributes
FMC	Forward Markets Commission	KYC	Know Your Customer
FME	Icelandic Financial Supervisory Authority	LAB	Local Area Bank
FMI	Financial Market Infrastructure	LAC	Loss Absorbing Capacity
FROB	Fund for Orderly Bank Restructuring	LBHI	Lehman Brothers Holdings Inc.
FRA	Financial Resolution Authority	LBIE	Lehman Brothers International (Europe)
FSA	Financial Services Authority	LCR	Liquidity Coverage Ratio
FSB	Financial Stability Board	LGD	Loss Given Default
FSCS	Financial Services Compensation Scheme	LIC	Life Insurance Corporation of India
FSDC	Financial Stability and Development Council	MCX	Multiple Commodity Exchange
FSLRC	Financial Sector Legislative Reforms Commission	MCX-SX	MCX Stock Exchange Limited
G20	The Group of Twenty	MCX-SXCCL	MCX SX Clearing Corporation Limited
GDP	Gross Domestic Product	MMCB	Madhavpura Mercantile Co-operative Bank
GFC	Global Financial Crisis	MMOU	Multilateral Memorandum of Understanding
G-SIBs	Global Systemically Important Banks	MoU	Memorandum of Understanding
G-SIFIs	Global Systemically Important Financial Institutions	MPE	Multiple Point of Entry
G-SIIs	Global Systemically Important Insurers	MTM	Mark to Market
GTB	Global Trust Bank Limited	NABARD	National Bank for Agriculture and Rural Development
HMT	Her Majesty's Treasury	NBFCs	Non-Banking Financial Companies
HRE	Hypo Real Estate	NBFIs	Non-Bank Financial Institutions
IAIS	International Association of Insurance Supervisors	NDS-OM	Negotiated Dealing System Order-Matching
ICCL	Indian Clearing Corporation Limited	NHB	National Housing Bank
ICMB	International Center for Monetary and Banking Studies	NIC	National Insurance Company
IMF	International Monetary Fund	NOHC	Non-Operating Holding Company
IOSCO	International Organization of Securities Commissions	NPA	Non Performing Assets
IPF	Investor Protection Fund	NPS	National Pension System
IRDA	Insurance Regulatory and Development Authority	NSCCL	National Securities Clearing Corporation Limited
IRF	Inter Regulatory Forum	NSDL	National Securities Depository Limited
JV	Joint Venture	NSE	National Stock Exchange

NSFR	Net Stable Funding Ratio	SBICI	SBI Commercial and International Bank Ltd.
NTNI	Non-Traditional and Non-Insurance	SEBI	Securities and Exchange Board of India
OBC	Oriental Bank of Commerce	SEC	Securities and Exchange Commission
OTS	US Office of Thrift Supervision	SGF	Settlement Guarantee Fund
P&A	Purchase and Assumption	SIFI	Systemically Important Financial Institution
PCA	Prompt Corrective Action	SIPA	Securities Investor Protection Act
PD	Probability of Default	SPE	Single Point of Entry
PDMA	Public Debt Management Agency	SRR	Special Resolution Regime
PFM	Pension Fund Manager	SSS	Securities Settlement System
PFMI	Principles for Financial Market Infrastructure	TAFcUB	Task Force on Urban Co-operative Banks
PFRDA	Pension Fund Regulatory and Development Authority	TBTF	Too-Big-To-Fail
POP	Points of Presence	TM	Trading Member
PONV	Point of Non-Viability	TPO	Temporary Public Ownership
PRA	Prudential Regulatory Authority	TR	Trade Repository
PSS	Payment and Settlement System	UCB	Urban Cooperative Bank
PSS Act	Payment and Settlement System Act, 2007	UK	United Kingdom
QDP	Qualified Depository Participants	USA	United States of America
RBI	Reserve Bank of India	USD	United States Dollar
RBS	Royal Bank of Scotland	WaMu	Washington Mutual
RC	Resolution Corporation		
RCL	Reliance Capital Limited		
RCS	Registrar of Co-operative Societies		
RoA	Return on Asset		
RRB	Regional Rural Bank		
RRP	Recovery and Resolution Plan		
RTGS	Real Time Gross Settlement		
SARFAESI Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act		
SBI	State Bank of India		



## 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.

# CHAPTER 1

## Introduction

### Background

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

## Constitution of the Working Group

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

### Composition of Group

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## Structure of the report

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

## Acknowledgements

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

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

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

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

## CHAPTER 2

### International Practices and Global Initiatives

#### Global Financial Crisis – Drawbacks and Shortcomings

**2.1** The global financial crisis unfolding in August 2007 witnessed failure of a few high profile banks and financial institutions, also known as “Too-Big-To-Fail” (TBTF) institutions. The failure of these TBTF institutions had a contagion impact on the whole financial system and interrupted the financial intermediation process, also impacting the payment and settlement services provided by the financial market infrastructures (FMIs). The failure to perform the critical economic functions spilled over to the real economy.

**2.2** The authorities had to intervene and bail out the TBTF institutions. In order to contain the contagion effect and avoid the spillover that could undermine financial stability, the authorities introduced an unprecedented range of support measures, including blanket guarantees, liquidity provisions, recapitalization and expanded deposit insurance, which are together termed as government-funded bailouts. In case of some non-bank financial institutions, the authorities tried to use general corporate insolvency procedures leading to disorderly collapse with widespread effects.

**2.3** There are several estimates of the cost of the crisis to the public exchequer. The amount of support to the systemically important financial institutions (SIFIs)<sup>1</sup> during the crisis was about 25% of the world’s GDP<sup>2</sup>. Capital injection and asset purchase in G20 countries are estimated at around 2.1% of GDP. Fiscal cost of direct support for advanced G20 countries and emerging market economies has typically been 4% and 11% of GDP respectively. Cumulative output loss in the countries that experienced a systemic crisis is estimated at about 27% of their GDP.

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<sup>1</sup> SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

<sup>2</sup> IMF: Laeven and Valencia (2010), Geneva Reports on the World Economy (2010) jointly published by International Center for Monetary and Banking Studies (ICMB) and Centre International D’Etudes Monetaires Et Bancaires (CIMB).

**2.4** A few examples here will not be out of place. Banks like Fortis, Dexia, HBOS, Royal Bank of Scotland (RBS), Lloyds, etc. were hit by the financial crisis and were rescued by public money or supported by state guarantees. The Icelandic banks failed because their access to funding collapsed in light of global financial difficulties. The assets of these banks were ring-fenced by a policy decision by the parliament. In the case of Fortis, flaws and inadequacies in the resolution tool kits resulted in the group being split along national lines.

**2.5** The chaotic way in which Lehman Brothers was placed into bankruptcy led to a significant loss of market confidence and caused uncertainties about the location and return of client assets. This case reveals legal problems with widespread cross country operations of a financial institution. Cross country coordination under prevailing legal conditions proved difficult as Lehman repatriated all liquid assets to the US and the foreign jurisdictions had no legal claim on the entity. This thus shows that there was in effect a clear failure of cooperation and information sharing at a critical moment: insolvency. The Lehman case also highlights how disorderly bankruptcy can lead to a loss of access to key services, such as payment and settlement services, and may cause a disruption in these systems and across borders. This also showed that the market was not well-placed to withstand the exit of large and heavily interconnected financial institutions due to the negative externalities they posed on the stability of national economies and the global financial system.

**2.6** The case of the Anglo-Irish and Icelandic banks shows that solutions adopted were inefficient and bail-in may have offered some alternative depending on the structure of banks. The losses incurred by banks, like Dexia for example, could have been covered by bailing in shareholders and creditors, rather than employing public funds.

**2.7** In the case of American International Group (AIG), the losses were caused by the unregulated financial arm of AIG that operated like a hedge fund. The systemic threat of a disorderly bankruptcy was judged to be too large and the US authorities opted to infuse public funds. On being approached by the AIG's management, the US Government lent a total of USD 183 billion<sup>1</sup>. This illustrates how public support can lead to an open-ended commitment, involving a large burden on the taxpayer.

**2.8** At the time of start of Northern Rock's problems, the UK did not have a special resolution regime and relied on the traditional resolution tools. Northern Rock faced a severe liquidity problem, caused by the closure of its major funding market for residential mortgage

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<sup>1</sup>Geneva Reports on the World Economy jointly published by ICMB and CIMB (2010).



backed securities, and had a heightened probability of experiencing an insolvency problem. Because of the fear of contagion, Northern Rock was not allowed to fail in a way that could have jeopardised the large number of depositors.

**2.9** The cases of Fortis, Northern Rock, and Hypo Real Estate (HRE) also display problems associated with shareholders delaying or blocking the resolution path chosen by the authorities. After Fortis was split, the Belgian authorities sought to sell the Belgian entity to BNP Paribas. However, the legal battle involving the need for shareholder approval led to significant delay before the transaction with BNP Paribas could be achieved. Similarly, Northern Rock was encouraged by the authorities to seek a takeover by a different banking group. However, the deal could not be struck because of the requirement of approval from the shareholders, which did not materialise as the offers were considered by them to be materially below the traded share value. The takeover of HRE by the German Government also met with similar problems.

**2.10** The financial crisis has in particular illustrated shortcomings in crisis management frameworks of cross-border financial institutions, in addition to the shortcomings in the domestic national resolution frameworks. The collapse of the Icelandic banks and Fortis in the Benelux countries, as also the Dexia and Lehman Brothers showed that resolution of cross-border institutions may pose even more challenges. The reasons for this are manifold, making these institutions more difficult to resolve – (i) involvement of multiple home and host authorities; (ii) different legal systems; (iii) different mandates and objectives of several national authorities involved, and (iv) different standards for cooperation and information sharing arrangements.

**2.11** The complexity of group structures also proved to be burdensome in the crisis for the regulatory and supervisory authorities. For example, Lehman Group consisted of 2,985 legal entities that operated in about 50 countries. Many of these entities were subject to host country regulations while supervision was done by the Securities and Exchange Commission (SEC), through the Consolidated Supervised Entities (CSE) programme in the United States. The Lehman structure consisted of a complicated mix of both regulated and unregulated entities and was designed to optimise economic return while achieving compliance with legal, regulatory and tax requirements throughout the world. The functioning of the group was such that a trade performed in one company could be booked in another. The lines of business did not necessarily map to the legal entity lines of the companies. The group was

so organised that some essential functions such as management of liquidity were centralised in parent holding company, Lehman Brothers Holding Inc. (LBHI).

**2.12** The above cases point towards limitations of extant resolution framework to deal with large-size financial institutions with complex operations, lack of cross border resolution arrangements, limitations of depositor protection arrangements and moral hazard associated with government bailouts.

**2.13** The global financial crisis also illustrated the fact that there were no effective resolution tools in place to deal with SIFIs at an early stage. Majority of the jurisdictions had some form of bank insolvency procedure for exercising resolution measures for problem banks, but it was not extended to large and complex institutions. The prevailing bankruptcy framework that did exist in a number of jurisdictions may have worked well for resolution of smaller and domestically oriented banks as the authorities could find another bank to take over the problem bank or the bank could be liquidated with losses to creditors and uninsured depositors. The extant resolution toolkits were also not designed to take into account the special nature of credit institutions.

**2.14** This is clearly observable in the briefs given in **Box 2.1**, which details the resolution measures exercised in case of Fortis, Dexia, Washington Mutual and Icelandic banks.

#### **BOX 2.1**

##### **Glitnir bank, Kaupthing bank and Landsbanki (Iceland)<sup>1</sup>**

The Icelandic banks were finding difficulties in refinancing their short term debt. The banks were under huge foreign debt, with three major banks holding more than €50 billion in debt. Further, there was sharp depreciation in the Icelandic currency *Króna*, further adding to the woes. In fact, high interest rates in the period resulted in carry trading in the *Króna*. Central bank's intervention also could not stem the slide. High inflation was exacerbated by the Central Bank of Iceland that was increasing liquidity in the system. Other factors that were pivotal in the crisis were newspapers reports speculating nationalisation of Glitnir, high leverage of Kaupthing and other banks, and deteriorating Icelandic economy. Finally, Central Bank of Iceland and government could not guarantee payment of bank debts (especially depositors), leading to collapse of banks.

##### **Measures taken by the government**

- The government package provided powers to the Icelandic Financial Supervisory Authority (FME) to take over the functioning of Icelandic banks without nationalisation. It accorded preferential treatment for depositors in the event of liquidation. The government also allowed full guarantee to the retail deposits for Icelandic branches of Icelandic banks.
- On September 29, 2008 Icelandic government announced nationalisation of Glitnir bank with the purchase of a 75% stake for €600 million. Government informed that in absence of intervention, the bank would have ceased to exist. However, Glitnir was subsequently placed in receivership on October 7, 2008 by the FME.

<sup>1</sup> Basel Committee on Banking Supervision (2010), Danielsson and Zoega (2009), and Geneva Reports on the World Economy jointly published by ICMB and CIMB (2010).

- On October 7, 2008 the FME also placed Landsbanki in receivership, though the operations were kept open for business as usual. The deposits of the UK arm of the Landsbanki, viz., Heritable Bank, were transferred by the UK government (under Banking (Special Provisions) Act, 2008) to a Treasury holding company and then to ING Direct for GBP 1 million.
- The Icelandic government also directed substantial reduction in repayment to foreign investors that included investors from UK.
- In UK, the internet bank of the subsidiary of Kaupthing bank, viz., Kaupthing Edge was sold to ING Direct by the FSA after default on its obligations. The subsidiary Kaupthing Singer & Friedlander was put into administration. This resulted into a run on the bank and later, on October 9, 2008, FME placed Kaupthing bank into receivership.
- Due to fall in prices of stocks of these banks, their collateral value estimated at 300 billion krónur (€2 billion) also got eroded, and on October 21, 2008 the Central Bank of Iceland asked the remaining independent financial institutions for new collateral against their loans. Sparisjóðabanki bank, also known as Icebank expressed its inability to provide for new collateral and turned to the government for help.

#### **Measures taken by the regulators**

- For continued operations of Icelandic banks, FME ring-fenced the operations of Landsbanki and Glitnir. NBI (known as *NýiLandsbanki*) was set up on October 9, 2008 with 200 billion Krónur in equity and 2,300 billion Krónur of assets and NýiGlitnir was set up on October 15, 2008 with 110 billion Krónur in equity and 1,200 billion Krónur of assets. Kaupthing bank was rechristened as NýjaKaupthing on October 22, 2008 with 75 billion Krónur in equity and 700 billion Krónur of assets. Icelandic government provided equity in the three banks. Glitnir and Kaupthing were provided relief in terms of moratorium on payments to creditors from the Court.
- In UK, deposit insurance was paid under the Financial Services Compensation Scheme (FSCS) for transfer of deposits from the subsidiaries of Landsbanki and Kaupthing to ING Direct as also for insuring retail deposits of these banks.
- The FME took over domestic operations of the three largest banks though the international operations of these banks went into receivership. The country could resurrect banking system that has been pruned down substantially. The result of such austere and prudent measures has reaped dividends as the banks were not affected by the recent European sovereign debt crisis.

#### **Washington Mutual (US)<sup>1</sup>**

Washington Mutual (WaMu) business model was to cater to risky consumers of lower and middle class. It provided easy access to the least creditworthy borrowers to get financing. During 2007/08, the bank faced sub-prime losses. The problems of the bank and resultant apprehensions of the customers led to a run on the bank.

#### **Measures by the regulator and the government**

- On September 25, 2008, the US Office of Thrift Supervision (OTS) seized WaMu and placed it under the receivership of Federal Deposit Insurance Corporation (FDIC). Thereafter, WaMu's banking operations were acquired by JPMorgan Chase<sup>2</sup>. All depositors were fully protected and there was no cost to the deposit insurance funds.
- JPMorgan Chase acquired the assets, assumed the qualified financial contracts and made a payment of USD1.9 billion. Claims by equity, subordinated and senior debt holders were not acquired, hence, the bank's equity holders were wiped out as the stock prices plummeted. JPMorgan Chase acquired all assets but cherry picked liabilities like deposits, covered bonds and other secured debt, as also, all banking operations of WaMu. The assets and liabilities of the parent holding company as also, uninsured deposits over the coverage limit of USD 100,000 were left behind.
- Further, looking at the gravity of the situation, instead of waiting for end of business of Friday when generally the seizure of banks is carried out, the measure was carried out on Thursday. WaMu with more than USD 300 billion in assets was the largest bank failure in the US.
- A certain set of people including shareholders of WaMu felt that the seizure of the bank and giving the assets and branches of WaMu to JPMorgan Chase was not proper. They also felt that the OTS acted arbitrarily and WaMu seizure was politically motivated for the benefit of JPMorgan Chase.

<sup>1</sup>Source: Basel Committee on Banking Supervision (2010).

<sup>2</sup>FDIC press release dated September 25, 2008

### **Fortis (Benelux)<sup>1</sup>**

Fortis N.V. was a company active in banking, insurance and investment management. It was active in Belgium, Netherlands and Luxembourg (Benelux countries). Fortis was one of the members of the consortium that had announced acceptance of offer of 86% of the outstanding ABN AMRO stock. The acquisition was a part of the plan for rapid expansion of business operations. Fortis had to issue shares (at discount to existing shareholders) to finance this takeover bid. Further, to shore up its capital due to international financial crisis, it had to issue more shares, and eliminate dividend payout. All these factors resulted in fall in share prices, and over a period of time, the deteriorating health of the bank added to the apprehensions of the customers and the resultant withdrawals caused serious liquidity problems for the bank.

#### **Measures by the regulator and the government**

- The government of Luxembourg approached Fortis with an offer of assistance. Under the plan, Fortis would receive financial support from a private trust (Shanti Swami Privet Trust) against shares in Fortis bank. The plan also included selling off the Dutch ABN AMRO to the Dutch Government.
- Though other banks showed interest in taking over Fortis, it was partially nationalised on September 28, 2008, with the three Benelux countries investing a total of €11.2 billion (USD 16.3 billion) in the bank. Whereas Belgium took 49% of Fortis's Belgian banking unit for €4.7 billion, the Netherlands paid €4 billion for a similar stake in the Dutch banking business. Luxembourg provided €2.5 billion loan convertible into 49% of Fortis's banking division in that country<sup>2</sup>. At the same time, the initial plan to integrate the operations of ABN AMRO into Fortis was shelved.
- On October 3, 2008, the Dutch government announced purchase of the Dutch banking and insurance divisions of Fortis for €16.8 billion (USD 23.3 billion). Thereafter, Luxembourg government & SS Trust also increased their control from 49% to 52%. Luxembourg also bought parts of the Fortis company for a symbolic price of €1.
- On October 21, 2008, the Dutch government created a strong Dutch bank by announcing merger between ABN AMRO and Fortis Bank Netherlands.
- After the Dutch action, Belgian government arranged merger of Fortis Belgian unit (including the insurance and banking subsidiaries) with BNP Paribas as a majority shareholder. Though the Belgian and Luxembourg governments were reduced to minority shareholding, they retained blocking power in exchange for shares in BNP Paribas.
- Thereafter the Belgian government purchased the remaining shares of the Fortis Bank from Fortis Group and sold 75% of those to BNP Paribas, at an evaluation of €11 billion for the total company, to be paid by shares of BNP Paribas, thereby becoming the biggest shareholder in BNP Paribas (at 12%).
- It is reported that Dutch were left out of negotiations till a later date causing friction and distrust, and that if all three countries had been involved from the start, they could have saved Fortis in its entirety. The subsequent Dutch action resulted in bad press for Belgian government as general feeling was that Belgium was left with the messy parts of the company. Negotiations with BNP Paribas did not go smoothly, as they wanted only the banking parts and not the 'toxic' structured products. Belgium government had to agree to let Fortis Group deal with the 'toxic' structured products. The banking business was sold to BNP Paribas.

### **Dexia (Belgium)<sup>3</sup>**

Dexia N.V./S.A., is a Franco-Belgian bank active in banking, asset management, and insurance. During the sub-prime crisis, the bank faced losses at its US subsidiary FSA and from a huge loan to troubled German bank Depfa. It applied for bailout and received help from Belgian government in terms of capital injection and guarantees. The bank posted huge losses after writing down the Greek debt. It got the dubious distinction of being the first casualty of the 2011 European sovereign debt crisis.

#### **Measures by the regulator and the government**

Initial discussions pointed towards breakup of bank. On October 10, 2011, Belgian government announced purchase of the Belgian banking arm for Euro 4 billion. Luxemburg and French operations were sold to other financial institutions. For the remaining troubled assets, the governments of

<sup>1</sup>Dewatripont and Rochet (2009), Basel Committee on Banking Supervision (2010), and Geneva Reports on the World Economy jointly published by ICMB and CIMB (2010).

<sup>2</sup>Blomberg: Fortis Gets EU11.2 Billion Rescue From Governments. September 28, 2008.

<sup>3</sup>Van De Woestyne and Van Caloen (2009), Basel Committee on Banking Supervision (2010), and Geneva Reports on the World Economy jointly published by ICMB and CIMB (2010).

Belgium (60.5%), France (36.5%) and Luxembourg (3%) provided guarantees up to €90 billion. On July 27, 2012, 50% share in RBC Dexia Investor Services was sold to Royal Bank of Canada (RBC) and was renamed RBC Investor Services.

## Need for an Effective Resolution Regime

**2.15** A sound and effective resolution regime and a legal framework for cross-border cooperation could address shortcomings mentioned above. Had the relevant powers and tools been available to the relevant authorities in the cases of banks and financial institutions that were bailed out with public money and a legal framework for cross-border banks was existent and enforceable, the authorities could have achieved solutions that were less disruptive and did not involve use of taxpayers' money for resolution of cross-border banking groups. A sound resolution regime means that resolution authority adopts resolution tools that provide least cost solution and maintain financial stability rather than simply bail-out using taxpayers' money.

**2.16** The case of Bradford & Bingley illustrates such an example. When, in September 2008, the UK's Financial Services Authority (FSA) determined that the bank no longer met threshold conditions, UK authorities took Bradford & Bingley into temporary public ownership in terms of the emergency legislation, the Banking Special Provisions Act, which later became the Banking Act, 2009. Thanks to extensive prior contingency planning, the UK was able, over the space of a single weekend, to auction Bradford & Bingley's retail deposits, branches and associated systems to Santander, leaving the rest (mortgage operations) in public ownership which was liquidated over time. The Bradford & Bingley branches opened for business as usual on Monday morning with no interruption in service. Another example is Denmark's Amagerbanken - early in 2011, the Danish authorities demonstrated both their willingness and capacity to use the recently created bank resolution framework, imposing a 41% write-down of senior debt and unguaranteed deposits, and in so doing sent a strong signal that they may do so again in the future. Until this time, the Danish authorities had supported the unguaranteed depositors and senior creditors of failing banks via blanket guarantees, guarantees on debt issuance by the banks, and hybrid capital injections.

**2.17** The UK used its special resolution regime (Banking Act, 2009) first on the Dunfermline Building Society, which was small in operations. This was a case where three resolution tools were exercised in one go – the transfer powers, bank administration procedure and bridge bank. During the weekend, depositors, branches and the head office, and prime mortgage assets were transferred to Nationwide Building Society; the social housing loan book and some associated deposits were transferred to a bridge bank owned

and run by the Bank of England; and worse quality assets, mainly commercial property loans and bought-in mortgages, were placed into a building society special administration procedure. The bridge bank was run for three months and finally sold. With the exercise of timely effective resolution tools, the resolution of Dunfermline was a success and on Monday morning depositors knew their money was safe. The only problem was the lack of proper resolution funding arrangements. It is, however, not clear if the tools that can be applied in case of a small bank can work in resolving a big bank/financial institution.

## Reforms in Resolution Regimes

**2.18** The financial crisis highlighted the need to significantly enhance existing resolution regimes. Many jurisdictions recognized the need to enhance resolution powers, enforce recovery and resolution planning measures, strengthen arrangements for domestic and cross-border cooperation in dealing with failing financial institutions, and develop mechanisms to recoup any public funds used in resolution. Moreover, an effective resolution regime would enhance market discipline by encouraging counterparties to focus more closely on the financial risks of the institution, fixing responsibility on the senior management and imposing losses on shareholders and, where appropriate, other creditors.

### Action taken by jurisdictions

**2.19** Work at the international level is under progress to address not only the issues of having effective national resolution frameworks, but also tackling the problems of complex group structures and cross-border crisis resolution mechanism. The reform process is at various stages in FSB jurisdictions. While some jurisdictions that were directly affected by the crisis have already undertaken major legislative reforms since the financial crisis to develop new or revise their existing resolution regimes, several other jurisdictions are in the process of adopting or implementing or considering those reforms to further strengthen their resolution regimes. Nine jurisdictions have recently enacted relevant legislation and are preparing for implementation of the rules and regulations.

**2.20** Eight jurisdictions<sup>1</sup> and the European Commission have issued documents for public consultation and/or are in the process of preparing draft legislations to further strengthen their resolution regimes, including by extending the regime to insurers, securities or

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<sup>1</sup> Australia (banks, insurers and FMIs), Brazil (banks, securities firms and FMIs), France (banks and investment firms), Germany (banks and FMIs licensed as banks), Indonesia (banks and insurers), Singapore (all FIs), South Africa (all FIs), and EU (legislative proposal covers banks and investment firms, while its consultation covers the need for a recovery and resolution framework for insurers and FMIs).  
Source: FSB's peer review report on thematic review on resolution regimes (2013).

investment firms and/or FMI. In addition, nine jurisdictions<sup>1</sup> are considering a variety of additional reforms to their resolution regimes. Several others are still planning to introduce reforms requiring enhanced resolution powers, undertaking more formal recovery and resolution planning, strengthen arrangements for domestic and cross-border cooperation, etc. for financial institutions that could have a systemic impact.

**2.21** Switzerland revised its existing special resolution regime contained in the Banking Act<sup>2</sup> in 2011 and 2012 to include specific requirements for systemically important banks and additional restructuring provisions. The provisions in the Banking law became effective on September 1, 2011 and March 1, 2012 respectively, the Banking Insolvency Ordinance became effective on November 1, 2012 and the Banking Ordinance on January 1, 2013. The UK and USA have enacted separate legislations, i.e. Banking Act, 2009 and Dodd-Frank Act, 2010 respectively for resolution of credit institutions and SIFIs respectively. Germany has enacted the Restructuring and Orderly Liquidation of Credit Institutions in December 2010 for resolution of banks. Canada amended the financial institution restructuring provisions of the Canada Deposit Insurance Corporation Act (CDIC Act) in March 2008, allowing the CDIC to act as a receiver, to assign assets and liabilities of a financial institution, including financial contracts, to a bridge institution. European Union is working to prepare a comprehensive resolution regime for all its member States. It has, in June 2012, published the draft framework for crisis management in the financial sector.

**2.22** After the crisis, significant efforts have been made by the US in adopting a framework for the resolution of SIFIs by enacting Dodd-Frank Act on July 21, 2010. A framework for resolution for banks and other financial institutions existed in the US under respective regulators and it worked well for relatively small and medium size institutions. The resolution framework as envisaged under Dodd Frank framework makes a distinction between systemic and non-systemic institutions. The financial firms that are non-systemic are resolved as per their respective laws, while the provisions of Dodd Frank Act apply in case of systemically determined firms. The Dodd-Frank Act also provides for a framework for better coordination among authorities, domestically and internationally, in recognition of the complexity and global reach of many SIFIs. The US regulators have promulgated rules implementing certain provisions of the Dodd-Frank Act and continue to develop rules to implement other provisions.

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<sup>1</sup>Canada, Hong Kong, India, Japan, Mexico, Russia, Saudi Arabia, Switzerland and United Kingdom.

<sup>2</sup> FINMA position paper (2012) on Resolution of global systemically important banks.

**2.23** Significant reforms have been initiated in the UK as well, with clarification in roles played by different agencies. Pre-crisis, the resolution of UK banks had relied on general corporate insolvency law. The Bank of England (BoE) now acts as the lead resolution authority for failing UK banks and building societies under the Special Resolution Regime (SRR) introduced by the Banking Act, 2009. The Banking Act establishes a permanent resolution framework built around a SRR for resolving banks, which includes a set of directed transfer powers (referred to as “stabilization powers” in the Banking Act) and a Bank Insolvency Procedure (BIP) for winding up insolvent banks in a manner protecting insured depositors. The Banking Act, 2009, inter alia, sets out the trigger points for invoking the SRR, the objectives of the SRR, the various stabilization (i.e., transfer) options under the SRR, and the tools for achieving the desired results. The Banking Act confers powers on the BoE and Her Majesty’s Treasury (HMT) to effect specific stabilization options in various situations and creates an obligation to consult with other authorities.

**2.24** In the light of challenges faced in the European Union (EU) region because of complex cross-borders operations of banks, EU has proposed a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms. The Directive establishes a regime relating to the recovery, resolution and orderly dissolution of failing credit institutions and certain investment firms and their subsidiary financial institutions and firms that are covered by the supervision of the parent undertaking on a consolidated basis. The regime also applies to financial holding companies, mixed financial holding companies, mixed activity holding companies and branches of institutions having their head office outside the EU under the specific conditions laid down in the Directive. The proposed Directive requires EU member states to appoint one or more public administrative authorities as resolution authorities that can be central banks, financial supervisors, deposit insurance agency or special authorities. However, if a resolution authority is established within a supervisory institution, then the functional separation of two activities is suggested in order to minimise the risk of supervisory forbearance. In terms of institutional design for cross-border resolution, the proposed Directive envisages that group-level resolution authorities shall establish resolution colleges with a clear leadership and with the participation of the European Banking Authority (EBA). All the national authorities involved in the resolution of institutions should be represented in resolution colleges.

**2.25** The progress in legislative reforms as well as in formulating special resolution regimes for financial institutions in various jurisdictions are detailed in **Annex 1**.



## Thematic Peer Review<sup>1</sup> on Resolution Regimes across Jurisdictions

**2.26** The Financial Stability Board (FSB) conducted its first thematic peer review of all FSB member jurisdictions to evaluate their existing resolution regimes and any planned changes to those regimes using the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) as a benchmark. The review provides a comparative analysis of the overall legal, institutional and policy framework of existing resolution regimes, both across individual Key Attributes and across different financial sectors (banking, insurance, securities or investment firms, and FMIs). The review focuses primarily on those Key Attributes that cover the core provisions of national resolution regimes applicable to any financial institution that could be systemically important or critical if it fails. As such, the review has not examined the implementation of those Key Attributes (Key Attribute 8 relating to Crisis Management Groups, and Key Attribute 9 relating to institution-specific cross-border agreements) that are relevant and apply only to the G-SIFIs. The peer review report was published on April 11, 2013. The key features of the findings of the thematic peer review are briefed in **Annex 2**.

**2.27** The peer review highlights that while major legislative reforms have already been undertaken by some FSB jurisdictions (particularly those that got directly affected by the financial crisis) to develop special resolution regime, several jurisdictions are at an early stage of reforming their resolution regimes. The resolution regimes are generally more developed and advanced for banks and progressively less for insurers, securities or investment firms and FMIs. This shows that the mandates as well as powers as specified in the Key Attributes are not available for resolution of insurers, securities or investment firms and FMIs. Powers for non-bank financial institutions are often supervisory in nature or are limited to firm liquidation or wind up at the initiative of the supervisor or in some cases through some form of specially adapted insolvency regime.

**2.28** Most of the jurisdictions lack powers to take control of the parent or affiliates of failed financial institution particularly when the financial holding company or affiliates are unregulated. Similarly, cross-border cooperation and coordination is less well-developed

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<sup>1</sup>Thematic reviews focus on the implementation and effectiveness, across the FSB membership, of international financial standards developed by standard-setting bodies and policies agreed within the FSB in a particular area important for global financial stability. The objective of peer reviews are to encourage consistent cross-country and cross-sector implementation; to evaluate the extent to which standards and policies have had their intended results, and to identify gaps and weaknesses in reviewed areas and to make recommendations for potential follow-up by FSB members.

across all sectors in most of the jurisdictions owing to lack of consistency in national legal frameworks. Moreover, very few jurisdictions have ability to give effect to foreign resolution actions, which can undermine the legal certainty of resolution actions initiated in home jurisdiction in case of a cross-border financial institution. Another major weakness highlighted is the power to share non-public information with other domestic and foreign authorities for the specific purpose of resolution of a particular financial institution.

## Multilateral Global Initiatives

**2.29** The financial institutions, especially the banks and insurance firms, have so far been considered to be the most heavily regulated sectors of the global economy. Given the central role banks play in any economy, a safety net framework has evolved over a period of time to prevent the failure of individual banks, or resolve it in a non-disruptive manner, if necessary. The safety net typically consists of prudential regulation and supervision, lender of last resort for providing temporary liquidity support, resolution framework and deposit insurance. The steps have also been taken to strengthen the regulation and supervision of other non-bank institutions, especially the insurance sector and the FMIs. These roles are played by different authorities or combined in one or more agencies.

**2.30** During the recent financial crisis, capital standards proved to be inadequate in terms of quantity as well as quality on a going concern basis. The resolution framework for SIFIs did not exist, though the regime worked for small and medium-sized banks. The emphasis since the crisis has been on ensuring that every jurisdiction has an effective financial safety net and crisis management frameworks in place and development of additional measures that could be taken to address the risk of failure of SIFIs, including banks and non-banks.

**2.31** Since the global financial crisis, there has been increased focus on financial crisis management. A consensus has emerged that addressing the “too-big-to-fail” (TBTF) problem requires a multipronged approach and integrated set of policies. This aspect prompted the G20 to initiate various initiatives to make the financial system more resilient as well as develop methodologies and standards to resolve the moral hazard problems. The global initiatives to strengthen the financial regulatory system have been driven by the G20 under the auspices of the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), to address, among others, the moral hazard risk posed by the TBTF institutions.

### ***Policy Measures to address SIFIs***

**2.32** The BCBS, based on an extensive stock-taking of legal and policy frameworks for cross-border resolutions and follow-up work on lessons learnt from the crisis, published in March 2010 a set of recommendations to facilitate effective cross-border bank resolutions (BCBS Recommendations)<sup>1</sup>.

**2.33** *Micro prudential regulations and enhancing resiliency:* Learning from the crisis, the Basel Committee published Basel III rules<sup>2</sup> in December 2010, which aim at strengthening micro prudential regulation as well as address the systemic risk which had not been addressed hitherto in financial regulation. The objectives of Basel III are to ensure that a crisis of such magnitude does not recur.

**2.34** *Reducing moral hazard posed by SIFIs:* In October 2010, the FSB, addressing the TBTF problem, released its Report on SIFI Framework for Reducing the Moral Hazard posed by Systemically Important Financial Institutions (SIFIs)<sup>3</sup> with 51 recommendations in 5 areas including SIFI resolution, as under:

- Global SIFIs must have higher loss absorbency to lower probability and impact of failure;
- SIFI resolution must be a viable option without taxpayer solvency support;
- SIFI supervision must be more effective to ensure proactive detection of problems and early intervention;
- Core financial infrastructures must be strengthened to lower contagion risk; and
- Effective and consistent implementation of national SIFI policies must be assured.

**2.35** *Effective resolution of financial institutions:* The FSB, in October 2011, developed an international standard – termed as *Key Attributes of Effective Resolution Regimes for Financial Institutions*<sup>4</sup> – as a point of reference for reform of national resolution regimes, setting out the responsibilities, instruments and powers that all national resolution regimes should have to enable authorities to resolve failing financial firms in an orderly manner and without exposing taxpayers to the risk of loss. In Cannes (November 2011), the G20 endorsed the FSB's core recommendations for effective resolution (Key Attributes of Effective Resolution Regimes for Financial Institutions), which jurisdictions are expected to implement to achieve these outcomes.

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<sup>1</sup>See [http://www.bis.org/publ/bcbs189\\_dec2010.pdf](http://www.bis.org/publ/bcbs189_dec2010.pdf).

<sup>2</sup>See <http://www.bis.org/publ/bcbs169.pdf>.

<sup>3</sup>See [http://www.financialstabilityboard.org/publications/r\\_101111a.pdf](http://www.financialstabilityboard.org/publications/r_101111a.pdf).

<sup>4</sup>See [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

**2.36** With the adoption by the FSB Plenary and endorsement by the G20 Leaders at the Cannes Summit, the FSB has laid down a work plan for full implementation of the Key Attributes by FSB member jurisdictions. A ‘Resolution Steering Group’ (ReSG) has been constituted under the FSB Steering Committee for supporting and monitoring the implementation of the FSB proposals.

### **2.37** *Identification and higher loss absorbency requirements for SIFIs*

- *Global systemically important financial institutions (G-SIFIs)*: The SIFIs, especially those that operate cross border, create negative externalities – failure or impairment of large, interconnected global financial institutions can send shocks through the financial system, which in turn could spill-over to the real economy – which the current regulatory policies do not fully address. In order to limit such cross-border negative externalities on the global financial system and related economies, the BCBS, in November 2011, published the rules text<sup>1</sup> on the assessment methodology for global systemically important banks (G-SIBs) and their additional loss absorbency requirements beyond the minimum Basel III standards. The additional loss absorbency requirements for G-SIBs will begin to apply from January 2016, applying initially to G-SIBs identified in November 2014, with full implementation by January 2019.
- *Domestic systemically important banks (D-SIBs)*: The FSB and BCBS have finalised and published, in October 2012, a principles-based minimum framework for addressing the externalities posed by D-SIBs<sup>2</sup>. The framework focuses on the impact that the distress or failure of D-SIBs will have on the domestic economy. The national authorities are required to apply requirements to banks identified as D-SIBs in line with the phase-in arrangements for the G-SIB framework, i.e. from January 2016.
- *Global systemically important insurers (G-SIIs)*: The International Association of Insurance Supervisors (IAIS) has, in July 2013, published an assessment methodology for identification of G-SIIs<sup>3</sup> and a set of policy measures that will apply to them. These policy measures, that are consistent with the policy framework published by the FSB in November 2011, include recovery and resolution planning requirements under the FSB’s Key Attributes, enhanced group-wide supervision, and higher loss absorbency requirements for non-traditional and non-insurance (NTNI)

<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>.

activities<sup>1</sup>. The assessment methodology comprises of 20 indicators segregated into five categories, viz. size, global activity, interconnectedness, NTNI and interconnectedness (together 80-90%). Supervisory judgement will play an important role in such assessments.

### *Guidance papers on recovery and resolution planning*

**2.38** As a part of its overall objective of developing policy measures for TBTF and moral hazard issues, and considering that the effective recovery and resolution planning in advance is the key to achieving the objective of effective resolution regime, the FSB published, on July 16, 2013, three guidance papers to assist authorities and financial institutions in implementing the recovery and resolution planning requirements under the Key Attributes. These documents are – (i) Guidance on Developing Effective Resolution Strategies<sup>2</sup>; (ii) Guidance on Identification of Critical Functions and Critical Shared Services<sup>3</sup>; and (iii) Guidance on Recovery Triggers and Stress Scenarios<sup>4</sup>.

### *Guidance on Developing Effective Resolution Strategies*

**2.39** The guidance is aimed at national authorities to assist them in drawing up, developing and maintaining their resolution strategies and operational resolution plans for SIFIs. The resolution strategies provide the key elements of the approach to resolution, which would involve use of one or in combination of resolution tools along with the relevant resolution powers in order to maintain financial stability and protecting critical functions without exposing taxpayers to loss. On the other hand, the operational resolution plan provides more specific details regarding the entities or firms to which the resolution powers are to be applied by one or more national resolution authorities, the conditions under which the plan might be implemented, and funding arrangements as well as the actions needed to implement the resolution strategy.

**2.40** The guidance document lays down two general approaches, i.e. Single point of entry (SPE), and Multiple point of entry (MPE), that are presently followed by the CMGs for resolution planning. The SPE involves the application of resolution powers at the top holding or parent company level by a single resolution authority, mostly the jurisdiction responsible for the global consolidated supervision of a group. The MPE involves the application of

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<sup>1</sup>Examples of NTNI activities include financial guarantee insurance, capital markets activities such as credit default swaps (CDS), transactions for non-hedging purposes, derivatives trading, or leveraging assets to enhance investment returns.

<sup>2</sup>See [http://www.financialstabilityboard.org/publications/r\\_130716b.htm](http://www.financialstabilityboard.org/publications/r_130716b.htm).

<sup>3</sup>See [http://www.financialstabilityboard.org/publications/r\\_130716a.htm](http://www.financialstabilityboard.org/publications/r_130716a.htm).

<sup>4</sup>See [http://www.financialstabilityboard.org/publications/r\\_130716c.htm](http://www.financialstabilityboard.org/publications/r_130716c.htm).

resolution powers by two or more resolution authorities to multiple parts of the group simultaneously, including strategies in which a group is broken into two or more separate parts. While the resolution of these parts would be under the direction or control of two or more national authorities, the home authority should play a role on ensuring that the resolution is coordinated, given the complexities and potential interdependencies.

**2.41** The successful implementation of a chosen resolution strategy will depend on a range of factors and considerations. The authorities should, among others, consider sufficient loss absorbing capacity, position of loss absorbing capacity in the creditor-hierarchy, and the critical economic functions and shared services provided by the particular financial institution. The loss absorbing capacity, which may take the form of equity, subordinated debt, senior unsecured debt, and other unsecured uninsured liabilities, needs to be available in sufficient amounts and at the right location to facilitate a recapitalisation or orderly wind down of the firm. The choice of the strategy needs to take account of the existing structure and business model of the individual financial institution and its particular characteristics. The critical procedural requirements and conditions as well as legal enforceability for applying the resolution powers by home and host authorities, etc. are other important factors that should be considered in the choice of a preferred resolution strategy. It should also consider some fall-back options in case the preferred resolution strategy cannot be implemented.

#### *Guidance on identification of critical functions and critical shared services*

**2.42** The FSB's guidance document on identification of critical functions and critical shared services is aimed at authorities and crisis management groups (CMGs) for their evaluation of the criticality of functions that firms provide to the real economy and financial markets. The aim is to promote a common understanding of which functions and shared services are critical by providing definitions and evaluation criteria. It should help to ensure that the resolution strategy and operational plan include appropriate actions that help maintain continuity of these functions.

**2.43** Though all products and services provided by financial institutions would have at least some impact on the economy and on financial stability if suddenly suspended, focus should be on those activities that have the most significant impact on financial stability. Such identification would help in prioritization of the resources of the firm to support these critical areas in the event of a failure. A resolution strategy will need to take into account the

materiality and the potential impact of failure of certain functions on the financial system and the broader economy.

**2.44** The guidance covers the functions and services provided by banks, but does not cover those provided by insurance firms<sup>1</sup> or FMIs, though some elements may be relevant to these sectors. Even within banks, the guidance focuses primarily on G-SIBs, however many aspects will also be relevant for D-SIBs.

**2.45** The guidance document proposes a two-part definition of “critical”, based on a distinction between “critical functions” and “critical shared services”. It also provides an indicative list of functions that could exhibit some degree of criticality. **Critical functions** are activities performed for third parties, where failure would lead to disruption of services vital for the functioning of the real economy and for financial stability due to the banking group’s size or market share, external and internal interconnectedness, complexity or cross-border activities - e.g. payments, custody, particular lending and deposit activities in the commercial or real sector, clearing and settling, limited segments of wholesale markets, market making in certain securities and highly concentrated specialty lending sectors. **Critical shared services** are activities performed within the firm or outsourced to third parties, where failure would lead to the inability to perform critical functions, and therefore to disruption of functions vital for the functioning of the real economy or for financial stability, e.g. information technology, facility management and administrative services.

#### *Guidance on Recovery Triggers and Stress Scenarios*

**2.46** Recovery plans, essentially developed and maintained by the financial institution’s senior management, identify options to restore financial strength and viability when the particular financial institution comes under severe stress. One of the essential elements of recovery plans is that they should define clear backstops and escalation procedures, identifying the quantitative and qualitative criteria that would trigger implementation of the recovery plan by the banking group. The aim of triggers in recovery planning is to enable firms to restore their financial viability before regulatory authorities see the need to intervene or enforce recovery options. Such triggers are generally in the form of early signals, which require the FIs to notify senior management or the Board, and also the supervisory authority, so as to implement a discretionary response in accordance with the condition. The document thus focuses on two specific aspects of recovery plans, i.e.:

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<sup>1</sup>The IAIS has forwarded its views and reasons why resolution in insurance is different from other segments of the financial sector and this is work in progress.

- (a) The design and nature of criteria triggering senior management consideration of recovery actions, a firm's reactions to breached triggers, and engagement of supervisor and resolution authority following breached triggers; and
- (b) The severity of the hypothetical stress scenarios and the design of stress scenarios more generally.

**2.47** The firms should not rely solely on well-defined quantitative triggers but should also incorporate qualitative criteria for initiating recovery actions. The supervisors should ensure that specific actions should be indicated in the recovery plans when triggers are breached. The document also specifies that the supervisors should ensure that firms use an appropriate number of market-wide stress scenarios and firm-specific stress scenarios to test the robustness of their recovery plans and to assess which options would be effective in a range of stress situations. The scenarios should address capital shortfalls and liquidity pressures and be severe enough to be useful in establishing triggers, estimating impacts of adverse situations, and contemplating responses to remediate adverse situations. The scenarios should be regularly updated and reviewed by the Board. The triggers and stress scenarios should be reviewed by supervisors as part of their general supervisory programme and review of the recovery plan.

## **FSB Work in Progress**

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

**2.49** In order to facilitate and support the implementation of the Key Attributes across jurisdictions in a consistent manner, the FSB is in the process of developing wide scale guidance and policy developments in various aspects of recovery and resolution planning for banks as well as standards, as Annexes to the Key Attributes, for insurers and non-bank financial institutions including FMIs.



### *Application of the Key Attributes to non-bank financial institutions*

**2.50** The Key Attributes constitute an umbrella standard for resolution regimes for all types of financial institutions. However, not all resolution powers and features set out in the Key Attributes are suitable for all sectors and all circumstances. Different types of financial institutions have distinctive features that need to be taken into consideration while applying the key attributes. Resolution regimes for FMIs need to give specific priority to maintaining continuity of the critical functions that FMIs perform in financial markets and take account of the loss allocation arrangements under the rules of certain FMIs; resolution regimes for insurers need to protect the policyholder interest; and the resolution regimes need to ensure rapid transfer and return of client assets in case of resolution of FI holding the client assets.

**2.51** With a view to assisting the jurisdictions and authorities in implementing the Key Attributes for orderly resolution of insurers, FMIs and firms with holding of client and custody assets, the FSB is formulating guidance on Application of Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions (NBFIs)<sup>1</sup>. The guidance on finalisation would be adopted as new Annexes to the *Key Attributes*. The draft document of the said Annex with respect to insurers, which is presently under consultation stage, is placed as **Annex 3**.

**2.52** In addition, the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commission (IOSCO) had jointly under the auspices of Bank for International Settlements (BIS) published, in July 2012, a consultative report on the Recovery and Resolution of Financial Market Infrastructures<sup>2</sup>. The report indicates that the disorderly failure of an FMI can lead to severe systemic disruptions if it causes markets to cease to operate effectively.

**2.53** The IAIS, while working on the Paper on Global Systemically Important Insurers: Initial Assessment Methodology<sup>3</sup>, has given consideration to the fact that the traditional insurance business model is different from banking and does not involve payment systems, credit intermediation or investment banking services. In November 2011, the IAIS published a report entitled Insurance and Financial Stability that describes the IAIS's view of the relationship between the insurance sector and financial stability, stressing the importance of the longer timeframe that applies to insurance liabilities and the importance of insurance

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

<sup>2</sup> Document is available at [www.bis.org/publ/cpss101.htm](http://www.bis.org/publ/cpss101.htm).

<sup>3</sup>See IAIS paper on Global Systemically Important Insurers: Initial Assessment Methodology (July 18, 2013).

techniques that rest on the pooling of insurance risks, including the notion of insurable interest. Insurance is founded on the law of large numbers, i.e. the aggregation of a large number of idiosyncratic risks ultimately results in a normal curve of distribution. The business model of insurance is based upon the assumption of a large number of ideally uncorrelated risks from policyholders to build up and maintain a well-diversified portfolio. In practice, this means that with an increasing portfolio there is less opportunity for unexpected results and a lower probability of very large losses (in relation to the entire portfolio). The insurance business underwrites risks, and insurance claims become due upon the occurrence of idiosyncratic claim events that relate to mortality, morbidity, property and liability risks.

**2.54** In general, insurance underwriting risks are not correlated with the economic business cycle and financial market risks and the magnitude of insurance events is not affected by financial market losses. Insurers are, however, exposed to risks faced by other financial institutions, including credit risk, operational risk, and market risk as well as interest rate and exchange rate risks. Nevertheless, the unique aspects of the insurance business model enabled most insurers to withstand the financial crisis of 2008-09 better than other financial institutions. While the effects of the crisis were certainly felt by the insurance industry, insurers engaged in traditional insurance activities in general were able to absorb the impact and demonstrated no impact on the broader financial system from a systemic risk perspective.

**2.55** In contrast, insurance groups and conglomerates that engage in non-traditional and non-insurance (NTNI) activities can be more vulnerable to financial market developments and may therefore be more likely to amplify, or contribute to, systemic risk, than traditional insurers. Examples of NTNI activities include financial guarantee insurance, capital markets activities such as credit default swaps (CDS), transactions for non-hedging purposes, derivatives trading or leveraging assets to enhance investment returns. In addition, the continually evolving marketplace is resulting in products and activities that blur the lines between traditional insurance and bank-type (or investment bank-type) activities.

#### *Information Sharing for Resolution Purposes*

**2.56** Constraints on timely sharing of non-public information between home and host authorities have emerged as basic challenge in planning, preparation and implementation of recovery and resolution planning as well as resolvability assessments. Differing terms and conditions, including differences in the confidentiality regimes that apply to authorities, as

well as hurdles in sharing of supervisory information with non-supervisory authorities, may impede or complicate cross-border information sharing for resolution purposes.

**2.57** In order to promote adoption of effective frameworks for information sharing consistent with the Key Attributes, the FSB is in the process of developing a document<sup>1</sup> to be incorporated as Annex to the Key Attributes. The document is intended to provide guidance on the standards for information sharing, confidentiality requirements, statutory safeguards, and information sharing within CMGs. It elaborates on the principles for the design of national legal gateways and related confidentiality regimes to facilitate effective sharing of non-public information between domestic and foreign authorities for resolution related purposes.

#### *Workstream on Data Templates*

**2.58** While the challenge of information sharing between authorities is expected to be addressed by the Guidance Document on Information Sharing for resolution purposes<sup>1</sup>, in order to facilitate effective collection of data in the cross-border context as also to have a common platform for collection of data, standardisation of data templates is considered necessary for collection of information for firms. Accordingly, the ReSG has constituted a workstream with a mandate to prepare data templates for effective data collections for cross-border resolution, both in normal times and in times of stress. The workstream is conducting a survey on firm-specific information needs for resolution planning purposes.

#### *Workstream on non-CMG Hosts*

**2.59** Generally, for reasons of operational efficiency, practicality, and effective decision-making, the membership of CMGs is limited to those jurisdictions and authorities that are material and significant for a group-wide resolution of the firm. Such a practice could possibly leave out some jurisdictions, where operations of the firm are locally systemic but not material in the context of the overall operations of the financial group, from representation in the CMG. However, the *Key Attributes* also require cooperation and information sharing between CMGs and authorities in other jurisdictions where the firm has a systemic presence locally but the particular jurisdiction does not participate in the CMG. Towards this end, a Workstream on non-CMG hosts, constituted by the Cross-Border Crisis Management Group to work on cooperation and information sharing between CMGs and non-CMG host authorities, is currently developing a guidance note on processes for

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<sup>1</sup>FSB has issued a consultative document in August 2013 for inviting comments. Please see [http://www.financialstabilityboard.org/publications/r\\_130812b.pdf](http://www.financialstabilityboard.org/publications/r_130812b.pdf).

identification of non-CMG host jurisdictions; criteria for assessing the systemic nature of G-SIB's presence in non-CMG host jurisdictions; types of cooperation and information sharing and minimum information to be exchanged between CMGs and non-CMG host authorities.

#### *Gone-concern loss absorbing capacity*

**2.60** One of the important parameters that is considered essential for development of effective resolution strategies for financial institutions include sufficient loss absorbing capacity and position of loss absorbing capacity in the creditor-hierarchy. In order to take forward the descriptive work on the nature, location and types of loss absorbing capacity and also to assess its effect on the implementation of the resolution strategy, the FSB is preparing, in consultation with the standard-setting bodies, a proposal on the nature, amount and location within a group-structure of G-SIFI loss absorbing capacity in resolution.

#### *Framework for cross-border recognition of resolution actions*

**2.61** The thematic peer review revealed that the resolution authorities of most jurisdictions do not have powers to give effect to foreign resolution measures in their jurisdiction. The FSB is in the process of developing proposals on methods for enhancing legal certainty in cross-border resolution, particularly with regard to bail-in and temporary stay of close-out rights. The ReSG is establishing a group of legal experts with a mandate to develop a proposal for a framework for the cross-border recognition of resolution actions. The mandate is to explore both statutory (e.g. mutual recognition) and contractual approaches whereby counterparties that may not otherwise be subject to certain resolution measures (e.g. bail-in or temporary stay) agree contractually to be bound by these measures.

#### *Funding and liquidity in resolution*

**2.62** The CMGs have been facing challenges in practical aspects of funding of firms in resolution in a cross-border context. The ReSG has constituted a workstream with a mandate to develop a paper on the role that the funding and liquidity play in supporting a successful resolution of a SIFI, both before and during the resolution. The purpose is to identify the sources, needs and shortfall of liquidity in resolution, and discuss possible methodologies to measure the funding requirements to bridge the liquidity shortfalls.

#### *Assessment Methodology*

**2.63** The FSB in association with the International Monetary Fund and the World Bank is currently developing assessment criteria and methodologies to facilitate assessments against the Key Attributes as well as to promote effective and consistent implementation

across jurisdictions. The implementation of the Key Attributes will also be subject to assessments under the IMF/ World Bank Financial Sector Assessment Program.

**2.64** The purpose of the methodology<sup>1</sup> is to guide the assessment of a jurisdiction's compliance with the Key Attributes and also to serve as guidance to jurisdictions that are adopting or amending national resolution regimes to implement the Key Attributes. Once finalised, the methodology will enable the Key Attributes to be included in the FSB's list of key standards for sound financial systems and to be used in country assessments by the IMF and World Bank under the Standards and Codes (S&C) Initiative.

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<sup>1</sup>FSB has issued a consultative document in August 2013 inviting comments. Please see [http://www.financialstabilityboard.org/publications/r\\_130828.pdf](http://www.financialstabilityboard.org/publications/r_130828.pdf).

## CHAPTER 3

### Existing Resolution Regime for Indian Financial Institutions

#### Brief Overview of FSB Key Attributes

**3.1** The Financial Stability Board (FSB) has proposed a set of twelve core elements viz. the Key Attributes, as essential components of an effective resolution regime for financial institutions. These Key Attributes call for an effective “Resolution Regime” to be in place in all jurisdictions that provides the resolution authority with a broad range of powers/tools and options to resolve a firm that is no longer viable and has no reasonable prospect of becoming so. As per FSB, a systemically important financial institution is ‘resolvable’ if it is feasible and credible for the resolution authorities to resolve it without losses to taxpayers on account of solvency support, while protecting vital economic functions. For resolution to be feasible, the authorities must have the necessary legal powers – and the practical capacity to apply them – to ensure the continuity of functions critical to the economy. For resolution to be credible, the application of those resolution tools would not itself give rise to unacceptably adverse broader consequences for the financial system and the real economy.

**3.2** The twelve Key Attributes that are expected to be part of the resolution regimes of all jurisdictions relate to the following:

- (i) **Scope** - A resolution regime should necessarily cover all financial institutions that are systemically significant or critical if it fails and should also extend to the holding companies of a firm, non-regulated operational entities within a financial group or conglomerate, and branches of foreign firms<sup>1</sup>.
- (ii) **Resolution authority** – Each jurisdiction should have a designated administrative authority/authorities responsible for resolving the financial institutions by exercising the resolution powers/tools under the resolution regime. In case of multiple resolution authorities within a jurisdiction for resolving the financial institutions falling under their respective regulatory/supervisory jurisdiction, their roles and responsibilities and mandates should be clearly defined and coordinated. In case of different resolution authorities for resolving entities of the same group within a jurisdiction, a ‘Lead Authority’ should be identified for coordinating the resolution of the legal entities within

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<sup>1</sup>This should not apply where jurisdictions are subject to a binding obligation to respect resolution of financial institutions under the authority of the home jurisdiction.

that jurisdiction. The resolution authority: (a) should have the expertise, resources and operational capacity to implement resolution measures; (b) should be operationally independent consistent with its statutory responsibilities; (c) should be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of resolution actions; (d) should be protected against liability for actions taken and omissions made in exercise of resolution powers in good faith; and (e) should have unimpeded access to firms for resolution planning.

- (iii) **Resolution powers** – The resolution of any financial institution should be initiated when a financial institution is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so, and before it is balance-sheet insolvent and all equity has been fully wiped out. In order to take decisions for initiating resolution, clear standards or suitable indicators of non-viability need to be formulated.

The resolution authorities should have a broad range of resolution powers, including powers to (a) remove and replace senior management and directors, (b) appoint administrator to take control, (c) terminate, continue or assign contracts, purchase or sell assets, write down debt and any other action to restructure or wind-down the financial institution's operations, (d) ensure continuity of essential services and functions, (e) override rights of shareholders to effect various resolution options, (f) transfer or sell assets and liabilities including deposit liabilities to a solvent third party, (g) establish a bridge institution to take over and continue operating certain critical functions and viable operations of a failed financial institution, (h) establish a separate asset management vehicle and transfer non-performing loans for management and run-down, (i) carry out bail-in within resolution, (j) temporarily stay the exercise of early termination rights, (k) impose a moratorium, (l) effect orderly wind-down with timely pay-out, and (m) apply one or combination of resolution powers.

- (iv) **Set-off, netting, collateralization, segregation of client assets** – The legal framework governing set-off rights, contractual netting and collateralization agreements and segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of financial institutions. Initiation of any resolution should not trigger statutory or contractual set-off rights, or entitle any counterparty to exercise contractual acceleration or early termination rights, provided the substantive obligations under the contract continue to be performed. Even in case of exercise of contractual acceleration or early termination rights, the resolution authority should have the power to stay temporarily such rights (strictly limited in time) arising due to resolution of financial institutions.

(v) **Safeguards – Respect of creditor hierarchy and “no creditor worse off” principle**

– Resolution powers should respect the hierarchy of claims and also provide for flexibility to depart from the general principle of equal treatment of creditors of the same class. Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the financial institution under the applicable insolvency regime (“no creditor worse off than in liquidation” safeguard). The legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of measures by the resolution authorities. With a view to preserving market confidence, the resolution authority should have the power to allow temporary exemptions from disclosure requirements or postponement of disclosures required by the financial institution.

(vi) **Funding of firms in resolution** – Statutory or other policies should be in place so as

to avoid relying on public ownership of bail-out funds as a means of resolving a failing firm. A privately-financed deposit insurance or resolution funds, or a funding mechanism should be put in place for *ex-post* recovery of the costs of providing temporary financing by the resolution authority to facilitate the resolution of the firm. Provisions should also be made, either from shareholders and unsecured creditors or from the wider financial system, for recovery of any losses incurred arising out of temporary funding by the resolution authority for orderly resolution. As a last resort, the resolution authorities could have power to place the firm under temporary public ownership and control (nationalization) in order to continue critical operations and seek to make arrangement for a permanent solution such as a sale or merger. Provision should strictly be made for recovery of losses from unsecured creditors or the financial system more widely.

(vii) **Legal framework conditions for cross-border cooperation** – The resolution

authority should have the power to enter into a cooperative solution with foreign resolution authorities. The legal provisions/regulations should not provide for automatic action in a jurisdiction as a result of initiation of resolution proceedings in another jurisdiction, but the particular jurisdiction should have the discretionary power to take action, if necessary, to achieve domestic stability in the absence of effective international co-operation and information sharing. The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority or to take measures on its own initiative to maintain financial stability. The national laws/regulations should not discriminate against creditors on the basis of their nationality, location of their claims or the jurisdiction where it is payable, and should be transparent and properly disclosed to all creditors including depositors. The resolution



authority should have the legal power, subject to adequate confidentiality requirements and protection for sensitive data, to share information including recovery and resolution plans (RRPs) pertaining to the financial group as a whole or to individual subsidiaries or branches, with relevant foreign authorities for implementing a coordinated resolution. Jurisdictions should also provide for confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

- (viii) **Crisis Management Groups (CMGs)** – With the objective of enhancing preparedness and facilitating the management and resolution of a cross-border financial crisis, both home and host authorities of all global systemically important financial institutions (G-SIFIs) should constitute and maintain CMGs. The membership of the CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes. The CMGs should cooperate closely with authorities in other jurisdictions where firms have systemic presence.
- (ix) **Institution-specific cross-border cooperation agreements (COAGs)** – For all G-SIFIs, an institution-specific cooperation agreement should be in place and made public if agreed by the concerned authorities, between the home and relevant host authorities that need to be involved in the planning and crisis resolution stages.
- (x) **Resolvability assessments** – The resolution authorities should regularly assess and evaluate the feasibility of resolution strategies (*continuity of critical financial services, extent of intra-group exposures and its impact on resolution, capacity of the firm to furnish detailed, accurate and timely information, and robustness of cross-border cooperation and information sharing arrangements*) at least for G-SIFIs and their credibility in the light of the likely impact of the financial institution's failure on the financial system. In order to improve a financial institution's resolvability, the supervisory authorities or resolution authorities should have powers, where necessary, to change a financial institution's business practices, structure or organization, reduce the complexity and cost of resolution, etc.
- (xi) **Recovery and resolution planning** – Jurisdictions should put in place a robust and credible Recovery and Resolution Plans (RRPs), containing the essential elements, for all G-SIFIs and those other financial institutions that could have an impact on financial stability in the event of its failure. The firm's senior management should have the responsibility to provide the necessary input to the resolution authorities for assessment of the recovery plans, and the preparation of the resolution plans by the resolution authority.
- (xii) **Access to information and information sharing** – There should not be any legal, regulatory or policy impediments hindering the appropriate exchange of information,

including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes. Sharing of all information relevant for recovery and resolution planning and for resolution should be possible in normal times and during a crisis at domestic as well as cross-border level. However, in case of sensitive information, information sharing may be restricted only among the top officials of the home and host authorities.

## Indian Financial System

**3.3** India's financial sector is diversified and expanding rapidly. It comprises banks, insurance companies, securities firms, non-banking financial institutions, provident and pension funds, mutual funds, and other financial entities.

**3.4** Banks dominate the Indian financial system<sup>1</sup> with 63 per cent of the total assets of the financial system, followed by insurance companies having 19 per cent of financial assets. Non-banking Financial Institutions, Mutual Funds, and Provident and Pension institutions have 8 per cent, 6 per cent, and 4 per cent of the total financial assets, respectively. Within banking system, the scheduled commercial banks account for 92.4 per cent of total banking assets (of which, public sector banks have 67.2 per cent, private sector banks have 18.7 per cent and foreign banks have 6.5 per cent) followed by co-operative banks (rural and urban), regional rural banks, and local area banks with 3.4 per cent, 2.7 per cent and 1.5 per cent, respectively. The figures show that within the banking system, the public sector banks dominate with 72.8 per cent of market share of banking assets and 83 per cent of branches<sup>2</sup>.

**3.5** The Indian banking system includes commercial banks, regional rural banks (RRBs)<sup>3</sup>, and co-operative banks [*State Co-operative Banks, District Central Co-operative Banks and Primary (Urban) Co-operative Banks*]<sup>4</sup>. As on March 31, 2013, the Indian banking system comprised 93 scheduled commercial banks [*26 public sector banks, 24 private sector banks, and 43 foreign banks with branch presence*], 64 RRBs, 31 state co-operative banks, 371 district central co-operative banks and 1,606 primary (urban) co-operative banks.

<sup>1</sup>Data pertains to end-March 2012.

<sup>2</sup>Duvvuri Subbarao (August 2013) – Speech on “Banking structure in India – Looking ahead by looking back.

<sup>3</sup>The Regional Rural Banks (RRBs) were constituted in terms of Regional Rural Banks Act, 1976. They are small in size and have a limited area of operations extending from 1 to 15 districts. They do not give big ticket loans.

<sup>4</sup>Urban Co-operative Banks (UCBs) are generally small banks having operations confined to a state. However, there are a few multi-state co-operative banks. The balance sheet size of these banks is much smaller than banking companies and public sector banks.

In addition to the above deposit-taking institutions, there are other financial institutions, such as 12,225 Non-Banking Financial Companies (NBFCs)<sup>1</sup>, 4 Development Financial Institutions, and 21 Primary Dealers (13 PDs are departmentally conducted by banks and 8 PDs are standalone) within the regulatory jurisdiction of the Reserve Bank of India.

**3.6** The Indian insurance sector<sup>2</sup> comprises 24 life insurance companies, 28 general insurance companies and one reinsurer company. The securities market<sup>3</sup> comprises 198 merchant bankers, 50 mutual funds, 210 venture capital funds, 26 stock exchanges, 2 depositories, 867 depository participants (of which 285 are connected with NSDL and 582 with CDSL), 62 Qualified Depository Participants, 9,532 stock brokers in cash segment, 4,964 corporate stock brokers, 3,066 stock brokers in equity derivative segment, 2,372 stock brokers in currency derivative segment, 55,542 sub-brokers, 32 debenture trustees, 6 credit rating agencies, etc. In addition, there are other financial institutions, such as Housing Finance Companies (HFCs), and provident & pension funds, which form a part of Indian financial system. The Indian financial system is supplemented by the financial market infrastructures (FMIs)<sup>4</sup> (payment systems, clearing houses, central counterparties, securities settlement systems, securities depositories, etc.).

## Regulatory Framework for Indian Financial System

**3.7** The regulation and supervision of the financial system in India is carried out by different regulatory authorities – the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority (IRDA), Securities and Exchange Board of India (SEBI), Pension Fund Regulatory and Development Authority (PFRDA), and Forward Markets Commission (FMC).

### *Reserve Bank of India*

**3.8** Reserve Bank of India (RBI) is the country's central banking authority and apart from the usual central banking functions like monetary policy formulation, is involved in the

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<sup>1</sup>NBFCs are companies registered under the Company Law, engaged in the business of loans and advances, acquisition of shares, stock, bonds, hire-purchase, insurance business, or chit business: but does not include any institution whose principal business is agriculture or industrial activity; or the sale, purchase or construction of immovable property.

<sup>2</sup>Information furnished by IRDA.

<sup>3</sup>Information furnished by SEBI and data pertain as on November 30, 2013.

<sup>4</sup> Financial Market Infrastructure (FMI) is defined as a multilateral system among participating financial institutions, including the operator of the system, used for the purpose of recording, clearing or settling payments, securities, derivatives or other financial transactions. It includes the systemically important payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs), and trade repositories (TRs).

regulation and supervision of commercial banks, regional rural banks, co-operative banks<sup>1</sup>, non-banking financial companies, development finance institutions and certain FMI's [*Real Time Gross Settlement (RTGS) System, Securities Settlement System (SSS), Clearing Corporation of India Limited (CCIL) and the Negotiated Dealing System Order-matching (NDS-OM)*]<sup>2</sup>.

**3.9** There is a dual control with respect to cooperative banks. Incorporation, management and winding up of primary co-operative banks<sup>3</sup> is regulated either by the authorities under State Cooperative Societies Acts of each state (if the societies are operating in a single state) or the Central Act, namely, Multi-state Cooperative Societies Act, 2002 (if the societies are operating in more than one state). Regulation of incorporation, management and winding up of state co-operative banks and district central cooperative banks<sup>4</sup> is with the authorities under the State Cooperative Societies Acts of each state. The banking functions of primary co-operative banks is regulated and supervised by RBI and that of rural cooperative banks, by the National Bank for Agriculture and Rural Development (NABARD).

#### *Securities and Exchange Board of India*

**3.10** Securities and Exchange Board of India (SEBI)<sup>5</sup> regulates the Indian securities market, including merchant bankers, mutual funds, venture capital funds, stock brokers, sub-brokers, debenture trustees, KYC Registration agencies, registrars and underwriters to stock issues, foreign institutional investors and credit rating agencies. In addition, it also regulates certain FMI's – stock exchanges (in cash market and derivatives market), depositories and clearing corporations.

#### *Insurance Regulatory and Development Authority (IRDA)*

**3.11** Insurance Regulatory and Development Authority (IRDA)<sup>6</sup> is the statutory body for the regulation and development of insurance industry in India. The IRDA regulates life insurance companies, general insurance companies and reinsurance companies. In

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<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).

<sup>2</sup>While RTGS and SSS are owned and operated by RBI, NDS-OM is owned by RBI and operated by CCIL. The CCIL acts as central counterparty for segments and also acts as trade repository in certain segments.

<sup>3</sup> Commonly referred to as Urban Cooperative Banks (UCBs).

<sup>4</sup>Commonly referred to as Rural Cooperative Banks.

<sup>5</sup>SEBI was constituted as an administrative organ in the Department of Economic Affairs vide a Resolution of the Government of India in April 1988, and later established in 1992 as the first statutory autonomous regulator in the Indian Securities Markets.

<sup>6</sup>IRDA was constituted in terms of Insurance Regulatory and Development Authority Act, 1999.

addition, IRDA also regulates intermediaries such as agents, corporate agents, brokers, third party administrators, surveyors and loss assessors and web aggregators.

#### *Pension Fund Regulatory and Development Authority*

**3.12** Pension Fund Regulatory and Development Authority (PFRDA)<sup>1</sup> is mandated to regulate the 'National Pension System' (NPS) for government employees as well as other citizens of India, through its registered intermediaries, such as Central Recordkeeping Agency (CRA), Pension Fund Managers (PFMs) for professional management and investment of subscriber funds, Points of Presence (POP's) for distribution of the product, Trustee Bank, Custodians, NPS Trust, and aggregators as per the agreement with these entities.

#### *Forward Markets Commission*

**3.13** The Forward Markets Commission (FMC)<sup>2</sup> regulates the commodity derivative markets. It includes six national exchanges facilitating forward trading in 113 commodities, and 11 commodity specific regional exchanges recognized for trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952.

#### *Other regulators*

**3.14** The housing finance companies are regulated by National Housing Bank (NHB). The Department of Company Affairs (DCA), Government of India regulates deposit taking activities of companies (other than NBFCs) registered under Companies Law.

#### *Regulation of Financial Conglomerates*

**3.15** In India, financial groups are identified as Financial Conglomerates (FCs) on the basis of their significant presence in two or more market segments (Banking, Insurance, Securities, Non-Banking Finance and Pension). RBI has limited powers<sup>3</sup> to call for information and to inspect jointly with other financial sector supervisors, the associate enterprises of banks. As an important step towards a more effective consolidated supervision of the FCs, the four financial sector regulators in India, viz. RBI, SEBI, IRDA and PFRDA, have signed a Memorandum of Understanding (MoU) for cooperation in the field of consolidated supervision and monitoring of FCs. The Inter Regulatory Forum (IRF) is

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<sup>1</sup> The PFRDA was originally established by the Government of India through a resolution dated 10th October, 2003 & 14th November, 2008, has since attained a statutory status post the passage of Pension Fund Regulatory and Development Authority Act, 2013.

<sup>2</sup>FMC was constituted as a statutory body in 1953 in terms of the Forward Contract (Regulation) Act, 1952.

<sup>3</sup> Section 29A of Banking Regulation Act, 1949 inserted by Act 4 of 2013 (w.e.f. 18-1-2013).

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 financial stability due to activities of the FCs.

## Financial Stability

**3.16** RBI's main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. The objective also encompasses to protect the public interest, or the interest of the banking policy, or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company.

**3.17** IRDA's objective is to protect the interests of the policyholders and to ensure the orderly growth of the insurance sector. The objective of SEBI is to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto. On the other hand, PFRDA promotes old age income security by establishing, developing and regulating pension funds, and also protects the interest of the subscribers to the schemes of pension funds and for matters connected therewith or incidental thereto.

**3.18** The existing legal framework does not explicitly provide statutory powers to any authority to maintain financial stability. With a view to establishing a body to institutionalize and strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination, the Government of India has, in consultation with the financial sector regulators, set up, in December 2010, the Financial Stability and Development Council (FSDC) headed by the Finance Minister, Government of India. The Council also deals with issues relating to financial literacy, financial inclusion, macro prudential supervision of the economy including the functioning of large financial conglomerates, and coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB) and any such body as may be decided by the Ministry of Finance from time to time. A sub-Committee of FSDC, headed by the Governor of RBI, has been constituted with the mandate to maintain financial stability and inter-regulatory coordination. The sub-Committee of the FSDC has also set up various Working Groups/Technical Groups to deal with wide-ranging issues connected with financial stability. These include – (i) Inter-regulatory Technical Group, (ii)

Technical Group on Financial Inclusion and Financial Literacy, (iii) Inter-regulatory forum for monitoring financial conglomerates, (iv) Early Warning Group, and (v) Working Group on Resolution Regime for Financial Institutions.

## Legal Framework for Resolution of Financial Institutions

**3.19** As of now, India does not have a special resolution regime or comprehensive policy or law on bankruptcy exclusively for the financial institutions as a whole. However, there are some provisions contained in various Acts which empower the respective regulator/supervisor and/or the central government to resolve different types of problem financial institutions in India. These provisions are contained in –

- Banking Regulation Act, 1949 and Companies Law for banking companies (private sector banks, foreign banks and Local Area Banks);
- State Bank of India Act, 1955, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, SBI (Subsidiary Banks) Act, 1959 and Banking Regulation (BR) Act, 1949 for public sector banks including State Bank of India and its subsidiaries;
- Banking Regulation Act (As Applicable to Co-operative Societies), 1966, the Multi-State Co-operative Societies Act, 2002 and respective State Co-operative Societies Acts for co-operative banks (State Co-operative Banks, District Central Co-operative Banks and Primary Co-operative Banks);
- Regional Rural Banks Act, 1976 and Banking Regulation Act, 1949 for Regional Rural Banks;
- Insurance Act, 1938 , Insurance Rules, 1939, IRDA Act, 1999 and the regulations framed thereunder for insurance companies;
- The Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 and Stock Exchanges and Clearing Corporations Regulations, 2012 for Securities companies/brokers and stock exchanges;
- The Reserve Bank of India Act, 1934 and Companies Law for Non-Banking Financial Companies; and
- Pension Fund Regulatory and Development Authority, 2013 for pension companies.

## Existing Resolution Regime and Assessed Gaps

**3.20** The present status and the assessed gaps in the Indian resolution regime, *vis-à-vis* the Key Attributes, in respect of all financial institutions, including banks, NBFCs, insurance companies, securities companies/brokers, pension funds and FMIs are given as under.

## Scope of resolution regime

**3.21** India does not have a special resolution regime or comprehensive policy or law on bankruptcy exclusively for the financial institutions as a whole. However, there are some provisions contained in various Acts which empower the respective regulator/supervisor and/or the central government to resolve different types of problem financial institutions in India. Though the resolution powers are limited as compared to FSB Key Attributes, the existing legal provisions contained in various Acts that govern the functioning of financial institutions are applicable for resolving the private sector banks, branches of foreign banks, public sector banks, co-operative banks, insurance companies, securities companies, non-banking financial companies, and FMI.

**3.22** The powers, however, vary from institution to institution. While the powers are inadequate and required to be enhanced in respect of banks and insurance companies to meet global best practices, they are absolutely minimal in respect of FMIs. The existing resolution regime in respect of co-operative banks is in the form of a supervisory action framework which envisages self-corrective action in the initial stages of weakness and involves stringent supervisory action in the event of financials not improving. Though there is no special resolution regime for FMIs, the provisions of Company Law apply. Similarly, the provisions of Company Law apply to the NBFC sector.

**3.23** However, the resolution powers are applicable only to the specific categories of licensed financial institutions on a solo basis and not to the institution's holding company or subsidiaries. As such, the existing legal framework does not permit the authorities to extend resolution proceedings to regulated or unregulated subsidiaries of a regulated entity or subsidiaries of a regulated or un-regulated entity's holding company.

## Resolution Authority

**3.24** There is no dedicated resolution authority responsible for overseeing and implementing resolutions of financial institutions as a whole. However, the respective regulators/supervisors and/or the central government have been exercising their powers under the statutes mentioned above, where considered necessary, for resolving the problem financial institutions falling under their respective regulatory jurisdictions and have been able to achieve their regulatory objectives, without involving taxpayers' money. Even for resolution of financial groups, there is no lead authority as of now though the FSDC has been institutionalized by the Government of India to strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination.



FSDC and its sub-committee are not statutory bodies and thus lack sufficient legal powers and backing to resolve a financial group in real time.

## Resolution Powers and Tools

### *Banking Companies, Foreign Bank Branches and Public Sector Banks*

**3.25** The legal provisions relating to the procedure and powers for amalgamation, merger or liquidation of entities is spread out in different enactments depending on the constitution of the entity. The foreign banks having presence in the form of branches are governed by the provisions of Banking Regulation Act, 1949 and to certain extent, the Indian Company Law. The provisions that provide powers to the RBI and/or the central government for resolution of commercial banks are detailed below.

#### *Power to appoint and remove directors*

**3.26** RBI is empowered to remove<sup>1</sup> any person who has been elected to be chairman of the Board of Directors or the Managing Director of a banking company, if it is of the opinion that such person is not a fit and proper person to hold such office. In addition, RBI has the power to remove<sup>2</sup> any chairman, director, chief executive officer or other officer or employee of the banking company (private sector banks, foreign banks and LABs) and appoint suitable person in that place. Additional directors<sup>3</sup> can also be appointed by RBI under certain circumstances.

**3.27** The Chairman and managing directors of SBI<sup>4</sup> and whole-time directors<sup>5</sup> of nationalised banks are appointed by Central Government in consultation with RBI. The central government has the power to remove the Chairman or Managing Director of SBI<sup>6</sup> and its subsidiaries<sup>7</sup> after consultation with the Reserve Bank. RBI is empowered<sup>8</sup> to remove directors of nationalised banks under certain circumstances and appoint additional directors<sup>9</sup>. The State Bank of India may, in consultation with the RBI and with the approval of central government, remove<sup>10</sup> certain directors of its subsidiary banks.

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<sup>1</sup>Section 10B (6) of BR Act, 1949.

<sup>2</sup>Section 36AA of BR Act, 1949.

<sup>3</sup> Section 36AB of BR Act, 1949.

<sup>4</sup>Clauses (a) and (b) of Section 19 of SBI Act, 1955.

<sup>5</sup> Section 9(3)(a) of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980.

<sup>6</sup>Section 24 of SBI Act, 1955.

<sup>7</sup>Section 29 of State Bank of India (Subsidiary banks) Act, 1959.

<sup>8</sup>Section 9(3B) of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980.

<sup>9</sup> Section 9A of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80.

<sup>10</sup>Section 31 of SBI (subsidiary banks) Act, 1959.

#### *Power to issue directions and prohibition from entering a particular business*

**3.28** RBI is vested with the power to give<sup>1</sup> directions to banks (banking companies and public sector banks) in public interest as also to prevent the affairs of a bank from being conducted in a manner detrimental to the interests of its depositors or prejudicial to its own interests. RBI may caution<sup>2</sup> or prohibit banks from entering into any particular transaction.

#### *Power to terminate contracts, write down debts, etc.*

**3.29** The power to terminate contracts or write down debts, etc., of banks has not been explicitly provided in the statutes. However, the powers under section 35A of BR Act, 1949 and the scope of the scheme that may be made by RBI under section 45 of that Act when a banking company is placed under moratorium are in very wide terms. It may therefore be possible in extreme cases to provide for termination of contracts, etc., to resolve a banking company.

#### *Power to override rights of shareholders*

**3.30** Shareholders of banks cannot come in the way of the exercise of any of the powers conferred on RBI or Central Government under any of the statutes in question. However, they have the right to challenge the decisions of RBI and central government in courts if they are aggrieved in any manner.

#### *Power to acquire and/or transfer or sell assets and liabilities, legal rights and obligations*

**3.31** The central government, in consultation with the RBI, is empowered<sup>3</sup> to acquire undertakings of banking companies, if it is satisfied that such banking company has failed to comply with RBI directions relating to banking policy issued under Section 21 or Section 35A of BR Act, 1949; or is being managed in a manner detrimental to the interests of its depositors. If the central government is satisfied that the undertaking of the acquired bank and its assets and liabilities should, instead of vesting in itself, be vested<sup>4</sup> in a company established under any scheme or in any corporation (referred to as the transferee bank), it may order the transfer of assets and liabilities of such undertaking to the transferee bank.

**3.32** Further, the Central Government can make a scheme<sup>5</sup>, after consultation with the Reserve Bank of India, for constitution of the transferee bank in relation to transfer of the

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<sup>1</sup>Section 35A of BR Act, 1949.

<sup>2</sup> Section 36(1)(a) of BR Act, 1949.

<sup>3</sup>Section 36AE of BR Act, 1949.

<sup>4</sup>Section 36 AE (4) of BR Act, 1949.

<sup>5</sup>Section 36AF of BR Act, 1949.

acquired undertaking including the property, assets and liabilities of the acquired bank, its capital, name and office, constitution of first Board of management, continuance of services of employees of the acquired bank, continuance of right of any person who is entitled to or is in receipt of, manner of payment of compensation to the shareholders of the acquired bank, etc.

#### *Power to supersede the Board and appoint administrators*

**3.33** The RBI is empowered to supersede<sup>1</sup>, after consultation with the central government, the Board of Directors of banking companies and to appoint<sup>2</sup> an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks<sup>3</sup>, SBI<sup>4</sup> and subsidiary banks<sup>5</sup> of SBI under certain circumstances and appoint Administrator.

#### *Power to apply for moratorium and prepare scheme of amalgamation*

**3.34** RBI is empowered to apply to the central government for suspension<sup>6</sup> of the business of a banking company and to prepare a scheme for its reconstruction or amalgamation with any other banking institution. The scheme may, inter-alia, contain provisions for the capital, assets, powers, rights, interests, authorities and privileges, liabilities, duties and obligations of banking company on its reconstruction or of the transferee bank; terms & conditions of transfer of business, properties, assets and liabilities of a banking company to the transferee bank; any change or appointment in/of the board of directors; alteration of memorandum articles of association of banking company on its reconstruction or of the transferee bank; reduction of interests or rights of depositors and other creditors; allotment of shares to the members of the banking company on its reconstruction or in the transferee bank on amalgamation, etc.

**3.35** As regards nationalised banks, the central government may, after consultation with the RBI, make a scheme<sup>7</sup>, inter-alia, for the reconstruction of any nationalised bank into two or more corporations or amalgamation of such banks.

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<sup>1</sup>Section 36ACA of BR Act, 1949.

<sup>2</sup>Section 36ACA (2) of BR Act, 1949.

<sup>3</sup>Section 18A of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.

<sup>4</sup>Section 24A of SBI Act, 1955.

<sup>5</sup>Section 35A of SBI (Subsidiary Banks) Act, 1959.

<sup>6</sup>Section 45 of BR Act, 1949.

<sup>7</sup>Section 9 (2) (c) of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.

### *Liquidation and appointment of liquidators*

**3.36** The RBI can make an application to the High Court<sup>1</sup> for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.

**3.37** The Reserve Bank can also make an application to the High Court for winding up<sup>2</sup> of a banking company, if the banking company has failed to comply with the statutory requirements (i.e. non-compliance of requirement of minimum paid-up capital and reserves; non-compliance of other statutory provisions), or has been prohibited from accepting fresh deposits, or if in the opinion of the RBI, the continuance of the banking company is prejudicial to the interests of its depositors or is unable to pay its debts, or a compromise or arrangement sanctioned by a court cannot be worked satisfactorily. RBI, SBI and any other bank notified by the central government shall be appointed as the Official Liquidator<sup>3</sup> in case of a banking company that is under any proceedings for the winding up by the High Court.

**3.38** The SBI<sup>4</sup>, subsidiary banks<sup>5</sup> of SBI, nationalised banks<sup>6</sup> and RRBs<sup>7</sup> cannot be liquidated under company law but can be placed under liquidation by an order of the central government.

**3.39** An analysis of various provisions of BR Act, 1949 shows that the RBI/central government do have the capacity to use certain resolution tools like private sector purchase tool (compulsory amalgamation), temporary public ownership tool and bridge bank tool in respect of private sector banks and branches of foreign banks. However, the existing legislation does not provide for other resolution tools like bad-bank and good-bank, bail-in within resolution, etc. for the resolution authority to exercise upon. As regards public sector banks, the existing legal framework does not provide any specific powers to the RBI or the central government to exercise any resolution tool, except for liquidation.

**3.40** The extant legal framework, however, does not specify or provide powers to the RBI or the central government to ensure continuity of essential services and functions of the failing banks. Exercise of any of the above mentioned powers do not require any express approval from the shareholders of the concerned bank in resolution.

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<sup>1</sup> Section 37 of BR Act, 1949.

<sup>2</sup> Section 38 of BR Act, 1949.

<sup>3</sup> Section 39 of BR Act, 1949.

<sup>4</sup> Section 45 of SBI Act, 1955.

<sup>5</sup> Section 57 of SBI (Subsidiary banks) Act, 1959.

<sup>6</sup> Section 18 of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.

<sup>7</sup> Section 26 of RRB Act, 1976.

### ***Urban Co-operative Banks***

**3.41** RBI has the power to supersede<sup>1</sup> the Board of Multi-State urban co-operative banks (UCBs). For UCBs under the State Co-operative Societies Acts, the RBI can request the Registrar of Co-operative Societies (RCS) to supersede the Board and in view of the provisions of the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961 such a requisition of the Reserve Bank has to be honoured by the RCS. However, in case of UCBs governed by the State Co-operative Societies Acts, the RBI can request the Registrar of Co-operative Societies (RCS) to supersede<sup>2</sup> their board and the same is binding on the RCS. RBI also has the powers to apply to Central Government for suspension of business and issue of Order of Moratorium. Accordingly, the Central Registrar of Co-operative Societies has the powers to prepare a scheme of amalgamation for such co-operative banks.

**3.42** Guidelines on merger of UCBs and transfer of assets and liabilities to commercial banks are in place but all such resolution strategies are voluntary and need consent of General Body of the bank. The RBI has the powers to restrict the activities and give directions<sup>3</sup> to a UCB and to a limited extent these can be considered as resolution measures not amounting to liquidation. On cancellation of the banking license by RBI, the liquidator is appointed by the State Government who carries out liquidation under the provisions of the State Co-operative Societies Act. The payment by DICGC in such situations is similar to that followed for commercial banks.

**3.43** The RBI does not have any other power or tools in order to effectively resolve these banks. However, within the existing legal framework, Memorandum of Understandings (MoUs) have been entered into by RBI with all the State Governments. A Task Force on Urban Co-operative Banks (TAFUCB) has been constituted in all States comprising of representatives from RBI, Government and the Federation with a mandate to find revival path for the viable urban co-operative banks and non-disruptive exit for the non-viable entities. These TAFUCBs have no legal backing.

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<sup>1</sup>Section 36AAA of BR Act, 1949 (AACS).

<sup>2</sup>Second proviso of Article 243ZL(1) of the Constitution of India introduced by the 97<sup>th</sup> amendment to the Constitution states that the provisions of BR Act also apply to supersession of boards of cooperative banks. However, a Division Bench of Gujarat High Court has held in *Rajendra Shah v. India* being WP (PIL) 166 of 2012 by order dated April 22, 2013 that the said 97<sup>th</sup> amendment is unconstitutional. The matter is pending in Supreme Court.

<sup>3</sup> Section 35A and 36 of BR Act, 1949 (AACS).

### ***Regional Rural Banks***

**3.44** In terms of RRBs Act, 1976, no provision of law relating to the winding up<sup>1</sup> of companies shall apply to a RRB except by order of the Central Government and in such manner as it may direct. The sponsor bank of RRBs may, at any time remove the Chairman from office subject to some conditions.

**3.45** Thus, the existing legal framework does not provide any specific powers to the RBI or the central government to exercise any resolution tool, except for liquidation, in respect of these banks.

### ***Non-Banking Financial Companies***

**3.46** Merger, amalgamation, acquisition, etc. of NBFCs are governed by Company law and there is no specific power with RBI to deal with such matters. The RBI Act, 1934, governing the activities of NBFCs, provides certain powers to the Reserve Bank of India for dealing with problem NBFCs. However, these are restricted to prohibition of deposit taking activities, alienation of assets and cancellation of Certificate of Registration for carrying out business. Under Section 45MC of RBI Act, the Reserve Bank may file a winding up petition to the judiciary. All provisions of company law are applicable to such winding up<sup>2</sup>.

**3.47** The Company Law provides that if the Central Government or the Reserve Bank of India, inter-alia, have sufficient reasons to believe that any company has become, for the purposes of the Act, *ibid*, a sick company<sup>3</sup>, they can make a reference in respect of such company to the Tribunal for determination of the measures which may be adopted with respect to such company. The Tribunal may, in turn, after considering facts in the matter, order for winding of the company. RBI Act also empowers RBI to call for information<sup>4</sup> from financial institutions and to give directions to those and to prohibit acceptance of deposit<sup>5</sup> and alienation of assets. The efficacy of these provisions for effecting resolution is doubtful.

**3.48** The above mentioned powers conferred upon the central government or the RBI do not relate in any way to the resolution powers as prescribed by the Key Attributes.

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<sup>1</sup> Section 26 RRB Act, 1976.

<sup>2</sup> Section 45MC(4) of RBI Act, 1934.

<sup>3</sup> Section 253(5) of Companies Act, 2013

<sup>4</sup> Section 45L of RBI Act, 1934.

<sup>5</sup> Section 45MB of RBI Act, 1934.

## ***Insurance Sector***

### *Power to issue directions*

**3.49** The IRDA is empowered to issue directions<sup>1</sup> to insurers generally or to any insurer in particular, if it is satisfied that it is necessary in the public interest; or to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policy-holders or in a manner prejudicial to the interests of the insurer; or generally to secure the proper management of any insurer.

### *Power to appoint and remove directors*

**3.50** IRDA has the power to remove<sup>2</sup> any director or the chief executive officer of the insurer, from office and appoint any suitable person in place of the director or chief executive officer who has been removed from his office. It is also empowered to appoint<sup>3</sup> one or more persons to hold office as additional directors of the insurer, provided the number of additional directors shall not exceed five or one-third of the maximum strength fixed for the Board.

### *Power to appoint Administrator*

**3.51** The Central Government, based on the report of the IRDA, is empowered to appoint an Administrator<sup>4</sup> to control the affairs and conduct the management of the business of the insurer.

### *Power to acquire and/or transfer undertakings of insurers*

**3.52** The central government has the power to acquire<sup>5</sup> the undertaking of an insurer, provided the government is satisfied that an insurer has persistently failed to comply with directions given under Section 34, 34-F or Section 34-G or any order made under Section 34-E, or is being managed detrimental to the public interest or to the interests of his policy-holders or shareholders.

### *Power of investigation and inspection by IRDA*

**3.53** On receipt of report of investigation conducted under Section 33 of the Insurance Act, IRDA may, inter-alia, cancel the registration of insurer or direct any person to apply to court for the winding of the insurer.

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<sup>1</sup>Section 34 of Insurance Act, 1938

<sup>2</sup>Section 34B of Insurance Act, 1938.

<sup>3</sup>Section 34C of Insurance Act, 1938.

<sup>4</sup>Section 52A of Insurance Act, 1938.

<sup>5</sup>Section 52H of Insurance Act, 1938.

#### *Power to make scheme of amalgamation*

**3.54** The IRDA may prepare a scheme<sup>1</sup> for the amalgamation of an insurer with any other insurer, provided it is satisfied that it is necessary to do so in the public interest, or in the interests of the policy-holders, or in order to secure the proper management of an insurer, or in the interest of insurance business of the country as a whole. Such scheme shall be sanctioned by the Central Government with or without any modification.

#### *Jurisdiction over foreign branches of Indian insurance firms*

**3.55** The IRDA is empowered to direct any branch outside India of an insurer incorporated in India, to stop carrying on insurance business<sup>2</sup> in the country in which such branch is situated within a specified period, not being less than one year, if it has reasons to believe that the working of any branch outside India of an insurer is generally resulting in a loss or that the affairs of that branch are being conducted in a manner prejudicial to the interests of the policyholders or the public interest..

#### *Winding-up*

**3.56** The central government is empowered<sup>3</sup> to constitute a Tribunal, which shall have the powers of a civil court, for the purpose of Section 52H to 52J (that provide for acquisition of the undertaking of insurers in certain cases). The Tribunal may order the winding<sup>4</sup> up of an insurer in accordance with the provisions of the Companies Act which shall be subject to the provisions of the insurance Act, 1938 and shall apply accordingly.

**3.57** The IRDA can also apply to the Tribunal for the winding up of an insurance company in specified circumstances<sup>5</sup>, namely failing to hold deposits under Section 7; continued failure to comply with the requirements of the Insurance Act for a period of three months after issue of notice of such failure; company appears to be insolvent on the basis of returns filed/investigation reports; or where continuation of the company is considered to be prejudicial to the interests of policyholders or public.

#### *Power of Tribunal to reduce contracts of insurance<sup>6</sup>*

**3.58** In case of winding up of an insurance company or in case of insolvency of any other insurer, the Tribunal may make an order for reducing the amount of the insurance contracts

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<sup>1</sup>Section 52H of insurance Act, 1938.

<sup>2</sup>Section 34G of Insurance Act, 1938.

<sup>3</sup> Section 52K of Insurance Act, 1938.

<sup>4</sup>Section 53 of Insurance Act, 1938.

<sup>5</sup> Section 53(2)(b) of Insurance Act, 1938.

<sup>6</sup> Section 55(2) of Insurance Act, 1938.



of the company. For this purpose, the assets and liabilities of the company and all claims in respect of policies issued by it shall be ascertained in such manner and on such basis as the Tribunal considers appropriate.

#### *Segregation of client assets*

**3.59** All insurance companies – both life and non-life – are required<sup>1</sup> to keep a separate account of all receipts and payments in case of each class of insurance business carried on by them. In case of winding up/insolvency of an insurer, the value of assets and liabilities of the life insurance business shall be ascertained separately from the value of any other assets or any other liabilities of the insurer. The Insurance Act provides that no assets shall be applied to the discharge of any liabilities other than those in respect of life insurance business<sup>2</sup>, except in so far as those assets exceed the liabilities in respect of life-insurance business. Thus, the assets, liabilities and the income derived from the assets of the ‘policyholders’ are clearly identifiable.

**3.60** Various provisions of Insurance Act, 1938 empower the IRDA and/or the central government to use certain resolution powers and tools like private sector purchase tool (compulsory amalgamation), and temporary public ownership tool in respect of insurance companies. However, the existing legislation does not provide for other resolution tools like bail-in<sup>3</sup> within resolution, etc. for the resolution authority to exercise upon.

#### *Financial Market Infrastructures (FMIs)*

**3.61** Financial Market Infrastructures (FMIs) are defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. FMIs comprise Central Counter Parties (CCPs), trade repositories, critical payment systems, securities settlement systems and central securities depositories. FMIs facilitate the clearing and settlement of monetary and other financial transactions, such as payments, securities and derivative contracts (including derivatives contracts for commodities).

#### *FMIs under regulatory jurisdiction of RBI*

**3.62** The FMIs that are within the regulatory jurisdiction of the RBI are the Real Time Gross Settlement (RTGS) System, Securities Settlement System (SSS), Clearing

<sup>1</sup> Section 52K of Insurance Act, 1938.

<sup>2</sup> Section 56 of Insurance Act, 1938.

<sup>3</sup> The regulatory provisions presently do not permit insurance companies to leverage their balance sheet.

Corporation of India Limited (CCIL) and the Negotiated Dealing System Order-matching (NDS-OM). While the RTGS and the SSS are owned and operated by the RBI, the NDS-OM is owned by RBI but operated by the CCIL. CCIL is the central counterparty, authorised by RBI under the Payment and Settlement Systems (PSS) Act, 2007, for transactions in government securities, CBLOs, market repo, foreign exchange spot trade and foreign exchange forward trade. CCIL is also a Trade Repository in the segments approved by the RBI.

**3.63** The PSS Act, 2007 designates the RBI as the authority for regulation and supervision of payment systems. However, the existing provisions of the PSS Act do not lay down any special resolution framework for payment systems. There is no provision in the RBI Act or the PSS Act at the moment either for recapitalization of or orderly wind down or reorganization of FMs regulated by the Reserve Bank. In the absence of a specific legal mandate, the insolvency proceedings as laid down under the Company Law would be applicable.

#### *FMs under regulatory jurisdiction of SEBI*

**3.64** SEBI regulates various types of FMs, such as (i) stock exchanges – Bombay Stock Exchange, National Stock Exchange, MCX SX, United Stock Exchange and other regional stock exchanges, (ii) Clearing Corporations - Indian Clearing Corporation Ltd. (ICCL), MCX-SX Clearing Corporation Ltd. (MCX-SXCCL), National Securities Clearing Corporation Ltd. (NSCCL), and (iii) the depositories – Central Depository Services Ltd. (CDSL), National Securities Depository Ltd. (NSDL), etc.

**3.65** Various provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 and Stock Exchanges and Clearing Corporations Regulations, 2012, Depositories Act, 1996 as well as Depository and Participants Regulations, 1996 give powers to SEBI to pass directions, appoint board members, remove board members and take such action as provided in Acts/Regulations against stock exchanges, depositories and clearing corporations.

**3.66** In terms of Section 12A of the Securities Contracts (Regulation) Act, 1956, SEBI is empowered to issue directions to any stock exchange or clearing corporation or agency or person providing trading or clearing or settlement facility in respect of securities, or to any person or class of persons associated with the securities market, or to any company whose securities are listed or proposed to be listed in a recognized stock exchange, if SEBI is

satisfied that it is necessary in the interests of investors or orderly development of securities market, or to prevent the affairs of any recognized stock exchange or clearing corporation or such other agency or person being conducted in a manner detrimental to the interests of the investors or securities market, or to secure the proper management of any stock exchange or clearing corporation or agency or person.

**3.67** SEBI has taken following regulatory measures in respect of FMs regulated by it:

- (i) All stock exchanges have a separate legal entity as a clearing corporation, which ensures that any risk to the capital of a clearing corporation will not spill over to the stock exchange. These clearing corporations/houses have comprehensive risk management models to protect themselves against the default of any of its members. The risk management model followed by these clearing corporations is briefed in **Box 3.1**.
- (ii) With a view to ensuring their financial capabilities and risk absorbing capacity, the minimum net worth requirement of stock exchanges and Clearing Corporations has been enhanced. The net worth of Clearing Corporation has been stipulated as ₹ 300 crore. As on March 31, 2013, networth of the three clearing corporations viz., ICCL, NSCCL and MCX-SX CCL was ₹ 420.99 crore, ₹ 949.8 core and ₹ 28.06 crore respectively. In case of insufficiency of funds during a default, the net worth of Clearing Corporation may be utilised.
- (iii) With a view to providing timely exit to non-operational stock exchanges or stock exchanges where the annual trading turnover on its own platform is less than ₹ 1000 crore, guidelines have been spelt out for de-recognition and exit, avoiding any possible scenario of their resolution.
- (iv) The SEBI (Depositories and Participants Regulations), 1996 provide for insurance against risks. Every depository is required to take adequate measures including insurance to protect the interests of the beneficial owners against risks likely to be incurred on account of its activities as a depository.
- (v) As per the Depositories Act, 1996, the depositories are required to indemnify the loss caused to the beneficial owner due to the negligence of the depository or the participant.

#### **BOX 3.1**

##### **Risk Management Model of Clearing Corporations**

The Clearing Corporations acting as CCPs impose different types of margins like initial margin, extreme loss margin, mark to market (MTM) margin and other types of margins to cover their exposures. In the

derivatives segment, there are position limits prescribed by SEBI to mitigate the risk arising out of concentration of positions. The initial margin on positions of a clearing member (CM) is computed on a real time basis i.e. for each trade. The initial margin amount is reduced from the effective deposits of the CM with the Clearing Corporation. For this purpose, effective deposits are computed by reducing the total deposits of the CM by ₹ 50 lakh (referred to as minimum liquid net worth). The CM receives warning messages on his terminal when 70%, 80%, and 90% of the effective deposits are utilised. On reaching 100%, the clearing facility provided to the CM is withdrawn. Withdrawal of clearing facility of a CM in case of a violation will lead to withdrawal of trading facility for all Trading Members (TM) and/or custodial participants clearing and settling through the CM.

Similarly, the initial margins on positions taken by a TM are computed on a real time basis and compared with the TM limits set by his CM. The initial margin amount is reduced from the TM limit set by the CM. Once the TM limit has been utilised to the extent of 70%, 80%, and 90%, a warning message is received by the TM on his terminal. At 100% utilization, the trading facility provided to the TM is withdrawn.

Also, SEBI has provided system of **Risk Reduction Mode** wherein the stock exchanges shall ensure that the stock brokers are mandatorily put in risk-reduction mode when 90% of the stock broker's collateral available for adjustment against margins gets utilized on account of trades that fall under a margin system. Such risk reduction mode shall include the following:

- a. All unexecuted orders shall be cancelled once stock broker breaches 90% collateral utilization level.
- b. Only orders with Immediate or Cancel attribute shall be permitted in this mode.
- c. All new orders shall be checked for sufficiency of margins.
- d. Non-margined orders shall not be accepted from the stock broker in risk reduction mode.
- e. The stock broker shall be moved back to the normal risk management mode as and when the collateral of the stock broker is lower than 90% utilization level

The margin models are back tested on a quarterly basis in order to assess the adequacy vis-à-vis exposures of CCPs. In addition to the above, CCPs also maintain a '**Settlement Guarantee Fund**' (SGF). The objective of SGF is to ensure that there is no delay in settlement due to failure of any member to honour his commitment on time. While there is no fixed formula for estimating the corpus of the fund, SEBI has prescribed certain factors for assessing the fair quantum of SGF, which inter-alia includes track record of default of member in last 10 years; settlement liability of top 10 brokers in the highest settlement in last one year. For determining the minimum level of corpus, certain norms have been prescribed which inter-alia includes a simultaneous default by top 10 brokers for highest settlement in last one year settlement liability-wise. CCPs regularly conduct stress tests to determine the adequacy of the SGF.

#### **Size of SGF**

As of October 31, 2013, the total size of SGF of Clearing Corporations of three stock exchanges is ₹ 44,381 crore – (i) Clearing Corporation of BSE (ICCL) has ₹ 3,439 crore; (ii) Clearing Corporation of NSE (NSCCL) has ₹ 39,321 crore; and (iii) Clearing Corporation of MCX-SX (MCX-SX CCL) has ₹ 1,620 crore.

#### **Composition of SGF**

The Fund consists of:

- (a) contributions from the Exchange;
- (b) interest, dividend or other income arising from investments of the Fund and from any utilisation from the Fund,
- (c) accretions arising from investments of the Fund,
- (d) any money or property which the Relevant Authority is entitled to appropriate to the Fund, and
- (e) any other funds, contribution (non-refundable) or penalties collected from Clearing Members, money or property which the Relevant Authority may decide to be the part of the fund from time to time,

### Utilisation of Fund

In the event of a clearing member being declared a defaulter and the clearing member fails to meet the clearing and settlement obligations to the clearing corporation arising out of clearing and settlement operations of such deals as provided in the Rules, Bye Laws and Regulations, the relevant authority may utilise the Fund and other monies to the extent necessary to meet the obligations.

There are a few instances during the last 10 years when the brokers faced financial difficulties. However, the collaterals maintained by them with the stock exchanges adequately covered the position of members. The number of such instances is three each on BSE and NSE. On NSE, there were two more instances of default by the brokers, however, this was because of the reason of their not paying to clients and there was no default at the time of settlement in stock exchange

According to information provided by BSE, in last 10 years, there has been no case of utilization of SGF on account of settlement default. However, NSE utilized members' deposits (given below) to recover settlement shortages on 3 instances totalling to about ₹ 16.23 crore, without using any funds from SGF.

Year	Segment	Member deposit utilized towards settlement shortage (in ₹ crore)	No. of members declared defaulter	Whether SGF was utilized
2004	CM	0.085	1	No
2007	CM	0.024	1	No
2013	F&O	16.12 (approx.)	1	No

Thus there was no occasion when the SGF was utilised by the stock exchanges. They could complete the settlements due to prompt corrective measures adopted by them.

### 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.

### Securities Firms

**3.68** As Securities and Exchanges Board of India (SEBI) is the regulator of the Indian securities market, it is vested with certain general powers and is responsible for regulation, registration, supervision of market participants, market surveillance, enforcement of the securities law, investors' education and protection and policy framework.

**3.69** In addition to certain FMI's described above, SEBI regulates various types of entities that are fee-based and fund-based. For the fee-based entities that do not take deposits/funds from investors/public in general and whose operations are limited to particular clients, in the event of failure, the impact may not be widespread. For the fund-based entities, which manage public/third party funds, such as mutual funds, asset management companies, etc., there are provisions specific to each such regulated entity to ensure their smooth functioning.

**3.70** Section 11B(iii) of the SEBI Act, 1992 empowers SEBI to issue directions, if it is satisfied that it is necessary to secure the proper management of any intermediary to protect the interests of investors in securities market and to ensure the orderly development of the securities market. Section 11(4) empowers SEBI to issue direction with pending enquiry/investigation.

**3.71** SEBI has the power to direct transfer of clients/investors to other intermediaries in case of intermediaries who have been debarred or whose registration has been suspended or cancelled.

#### *Power to appoint administrator/supersede the Board*

**3.72** In terms of the SEBI Act, 1992, SEBI is empowered to supersede the board and appoint administrators. In the past, SEBI has superseded the governing boards and appointed administrators in case of 6 stock exchanges. In case of CRB Mutual fund, based on the reports of financial irregularities by the sponsor, an administrator was appointed in the interest of unit holders.

#### *Mutual Funds:*

**3.73** Asset Management Company (AMC) of a mutual fund needs to separately maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund. Thus, change in viability position of the sponsors of the Mutual Fund does not per se affect the interest of mutual fund unit-holders, as the assets of Mutual Fund are separately held by Trust and are kept in safe custody of custodians appointed by Trustees.

**3.74** SEBI (Mutual Funds) Regulations, 1996 require quarterly review of the net worth of the asset management company by the trustees and in case of any shortfall, it is ensured that the asset management company makes up for the shortfall.

**3.75** SEBI may direct winding up of a scheme of a mutual fund, in the interests of unit holders. The procedure for winding up including priority of claims is also mentioned in regulations. The proceeds of sale realised shall be first utilised towards discharge of such liabilities as are due and payable under the scheme and after making appropriate provision for meeting the expenses connected with such winding up, the balance shall be paid to the

unit holders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

**3.76** The existing legal framework is inadequate to effectively resolve the above financial institutions in line with the FSB Key Attributes. The resolution framework for securities markets would need to take into consideration some factors<sup>1</sup>, i.e. (i) the existing funds (Settlement Guarantee Funds and Investor Protection Funds) created in securities markets; (ii) the insurance schemes already prescribed by SEBI for different intermediaries; (iii) risk profiles of different types of intermediaries in securities markets; and (iv) international practices in securities markets in this area.

### *Pension Fund Sector*

**3.77** PFRDA currently regulates National Pension System (NPS) through its registered intermediaries like Pension Funds Managers (PFM), Central Record Keeping Agency (CRA), POP, Custodian, Trustee Bank, NPS Trust, Aggregators, etc. as per the agreement with these entities. However, Section 12(1) (A & B) of the PFRDA Act, 2013 provides for inclusion of any other pension scheme not regulated by any other enactment apart from NPS. The agreement with the institutions under NPS architecture is applicable to a particular legal entity and not to the institution's holding company or subsidiaries. The NPS is available to Indian citizens through the intermediaries in India only. As per Section 25 of the Act *ibid*, no pension fund shall directly or indirectly invest outside India, the funds of the subscribers.

**3.78** PFRDA has the authority to monitor, take corrective action and also terminate the PFMs if they do not function as per the prescribed parameters to safeguard the interest of subscribers.

**3.79** PFRDA is required to submit a report<sup>2</sup> to the central government where the affairs of CRA or Pension Fund are conducted in a manner prejudicial to the interest of the subscribers. The central government may consider the report and appoint Administrators. The central government may, on a complaint received by PFRDA or suo-motu, after conducting an enquiry, supersede the management/Board of the intermediary<sup>3</sup> and appoint an Administrator.

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<sup>1</sup> SEBI has requested to include these comments in the Report.

<sup>2</sup>Section 19(1) & (2) of PFRDA Act, 2013.

<sup>3</sup>Section 31 (2) of PFRDA Act, 2013.

### *Power to take over management*

**3.80** PFRDA can take over the Board/Management<sup>1</sup> of an intermediary after conducting an enquiry upon contravention of provisions of the Act

**3.81** There are wide gaps in respect of resolution of problem or non-viable pension funds.

### **Resolution triggers**

**3.82** The Reserve Bank has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of three parameters, i.e. capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA), for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points. The PCA framework is applicable only to commercial banks and not extended to co-operative banks, non-banking financial companies (NBFCs) and FMs. This framework is to essentially bring about timely corrective action in times of banks' failure to meet prudential requirements, or regulatory violations or the depositors' interest is threatened in any other way.

**3.83** The RBI's regulatory guidelines on Basel III norms, applicable only to commercial banks, provides that a non-viable bank will be a bank which, owing to its financial and other difficulties, may no longer remain a going concern on its own, in the opinion of the Reserve Bank, unless appropriate measures are taken to revive its operations and thus enable it to continue as a going concern. The Point of Non-Viability (PONV) trigger event is the earlier of:

- (a) A decision that a conversion or temporary/permanent write-off, without which the firm would become non-viable, is necessary, as determined by the RBI; and
- (b) The decision to make a public sector injection<sup>2</sup> of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

**3.84** However, these triggers are not specific to taking actions in crisis resolution.

**3.85** Resolution powers of the IRDA are invoked when the apprehensions are raised through the following triggers:

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<sup>1</sup> Section 31(2) of PFRDA Act, 2013.

<sup>2</sup> This action would imply that the write-off/conversion of non-equity regulatory capital instruments must occur prior to any public sector capital infusion.



- (i) All insurers are required to be compliant with the solvency requirements as stipulated for insurance companies. The regulatory framework provides that each insurer shall maintain a solvency margin of 150% at all points in time. In case of an insurer's solvency falling below the stipulated requirement, the resolution trigger/ regulatory action would be triggered immediately. Under such circumstances, the IRDA would in the first instance require the insurance entity to take steps to restore the solvency margin.
- (ii) The second trigger for such action could be the promoters of the institution being in financial difficulty and the insurer's financial condition being impacted as a result of the same.
- (iii) The third trigger could be regulatory action against the promoter company by another supervisor (another sector regulator within the jurisdiction or by home country regulator in case of the JV partner).
- (iv) The fourth trigger could be the insurance company continuously breaching the limits of expenses of management.

**3.86** The above triggers do indicate certain pre-specified points, the breach of which would prompt the RBI and/or IRDA to take necessary regulatory action to avoid any further viability problems in the institutions. However, these are not clear triggers that would prompt the respective regulators to handover the problem institution to the resolution authority for initiating resolution actions. Even such a regulatory framework is practically absent in the case of other types of banks (i.e. co-operative banks, RRBs), FMs and securities firms and pension funds.

### **Set-off netting, collateralisation, segregation of client assets**

#### *Bilateral netting and set-off on default of particular claim*

**3.87** The Contract Act, 1872 provides freedom to the contracting parties to structure their rights and obligations in the manner best suited for them, as long as such contracts are not unlawful or opposed to public policy. Thus, bilateral netting arrangement, including close-out netting contracts, on default of a particular claim would fall within the legal framework.

#### *Bilateral netting and set-off on bankruptcy of a party*

**3.88** Section 47 of the Presidency Towns Insolvency Act, 1909<sup>1</sup> and Section 46 of Provincial Insolvency Act, 1920<sup>1</sup>, provide that when there are mutual dealings between the

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<sup>1</sup>Presidency Towns Insolvency Act, 1909 govern the insolvency proceedings of individuals and partnership firms in presidency towns, i.e. Calcutta, Bombay and Madras.

insolvent and the creditor, set-off is permissible and sum due from one party shall be set-off against any sum due from the other party and the creditor may prove only the net balance due from the insolvent. Further, the Company Law provides that in the winding up of an insolvent company, the same rules regarding the (i) debts payable, (ii) valuation of annuities and future and contingent liabilities, and (iii) the respective rights of secured and unsecured creditors, shall prevail as in the case of law of insolvency relating to the insolvent persons. As the banking companies are registered under the Company Law, the same is applicable to private sector banks at the time of their winding up. As such, since the dealings between two banking companies would be mutual in nature, they can set-off the amount due between them and only the net amount would be claimed by the creditor bank from the liquidator of the banking company in liquidation without reopening the earlier trades between each of the members. However, this will hold good only for those banks and other financial institutions that are governed by the Company Law and the two insolvency legislations mentioned above.

**3.89** The other banks (i.e. public sector banks and RRBs) that are statutory corporations (governed by their own statutes) and co-operative banks (governed by the respective State Co-operative Societies Acts and Multi-State Co-operative Societies Act, 2002) do not have similar provisions in their statutes permitting set-off of claims in liquidations.

#### *Bilateral close-out netting*

**3.90** There are no specific provisions for close-out netting in the extant legal framework. However, even if the liquidator refuses to acknowledge the liability as a currently enforceable liability and treats it as a future liability, the fact that the debt has not matured when the insolvency commenced would not be of material consequence as the effect of the banking company's insolvency would accelerate the date on which the set-off should be effected and make the commencement of the winding-up/insolvency the time for that purpose. There are various court judgments<sup>2</sup> (Madras and Kerala High Courts) which had acknowledged that a debt, although not presently payable, can be set off against moneys owing to a company in liquidation. These are, however, applicable only for those banks, NBFCs and FMIIs that are covered by the Company Law, the Provincial Insolvency Act, 1920 and the Presidency Towns Insolvency Act, 1909.

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<sup>1</sup> Provincial Insolvency Act, 1920 governs insolvency proceedings of individuals and partnership firms in other places.

<sup>2</sup> (i) K. Anantaraman v. Official Liquidator, Travancore National & Quilon Bank Ltd. reported in [1939] 9 Comp Cas 285 (Mad.); (ii) Isaac v. Palai Central Bank Ltd. reported in [1963] 33 Comp Cas 799 (Ker.).

**3.91** Close-out netting of contracts in respect of co-operative banks would be governed by the provisions contained in the respective State Co-operative Societies Acts. Under the Maharashtra Co-operative Societies Act, 1960, the liquidator has the power to acquire custody and control of all actionable claims to which the society is entitled, on an interim order directing a society to be wound up. It also has the power to investigate all claims and decide on priority arising out of such claims and pay to any class of creditors in full or rateably according to the amount of such debts, compromise all debts and liabilities and all claims present or future, certain or contingent, subsisting or supposed to subsist between the society and contributory or other debtor, etc. on such terms as may be agreed. The close-out netting of contracts would, therefore, depend on the liquidator whose powers are subject to the control of the RCS.

#### *Multilateral netting arrangements of banks*

**3.92** Multilateral netting takes place where clearing/settlement services are involved. Such payment systems are governed by the provisions of the Payment and Settlement Systems (PSS) Act, 2007. Section 23 of the PSS Act, 2007 overrides the provisions of Companies Act, 1956, BR Act, 1949 and all other Acts and confers settlement finality in the case of insolvency of a system participant. It provides that such insolvency shall not affect a settlement that has become final and irrevocable. Basically a netted settlement is final and irrevocable as soon as the money payable under that settlement is determined.

**3.93** However, arrangements not governed by the provisions of PSS Act, 2007 would not get the benefit of multilateral netting arrangements. An FMI like CCIL has powers to close-out positions. Moreover, segregation of client assets is a part of extant regulations as is collateralization. Special provisions are being suggested to be provided by amendment to the PSS Act, 2007 for closing out position in the event of resolution of the FMI.

**3.94** However, the extant legal framework, being not uniform for all banks and not providing specific provisions thus lacking clarity and transparency, falls short of the provisions contained in the FSB Key Attributes.

#### **Temporary stay of early termination rights**

**3.95** The existing legal framework does not empower the regulators and/or the central government to impose temporary stay on exercise of early termination rights.

## **Safeguards regarding respect of creditor hierarchy**

**3.96** Though there are some provisions in the Company Law that provide seniority of claims in liquidation, it is not clear for other banks. However, the RBI's guidelines do indicate clear framework of creditor hierarchy in respect of failure of banks. In case of insurance companies, the scheme formulated under section 37A of the Insurance Act, 1939, to the extent that the assets are available over and above the liabilities of the regulated entity, the shareholders and creditors would get a share of such assets in case of winding up.

**3.97** In case of acquiring of the undertakings of banking companies by the Central Government or transferring the same to any company established for the purpose or in any corporation, every person, in terms of Section 36AG of Banking Regulation Act, 1949, who, immediately before the appointed day, is registered as a shareholder in the acquired bank or, where the acquired bank is a banking company incorporated outside India, the acquired bank, shall be given by the Central Government or the transferee bank, as the case may be, such compensation as is determined in accordance with the principal contained in the Fifth Schedule of the Banking Regulation Act, 1949.

**3.98** The Central Government or the acquiring insurer is required to make payment of compensation to the acquired insurer in respect of the transfer of the undertaking of the acquired insurer. The amount of compensation shall be decided by the central government or the acquiring insurer. If the amount of compensation is not acceptable to the acquired insurer, the matter shall be examined by the Tribunal, constituted for the purpose by the central government. The decision of the Tribunal shall be final.

**3.99** There are, however, no clear legal provisions that indicate safeguards that should be provided to the creditors of the failing financial institutions in case of initiation of resolution actions/proceedings.

## **Protection by law from actions taken for complying with the decisions of resolution authority**

**3.100** Since the directions issued by the Reserve Bank are statutory in nature, the directors and officers complying with such directions would be acting as per the legal mandate. Unless they deviate from the directions in their actions, they would be getting protection available under law. Section 54 of the Banking Regulation Act, 1949 specifically provides that no suit or other legal proceedings shall lie against the Central Government, Reserve Bank of India or any officer for anything which is done in good faith or intended to be in

pursuance of the provisions of that Act. No claim for damages also would lie against them. There is a similar provision in the Reserve Bank of India Act, 1934<sup>1</sup>.

**3.101** No suit, prosecution or other legal proceedings shall lie<sup>2</sup> against the central government or any officer of the central government or any member, officer or other employee of the IRDA for anything which is done in good faith or intended to be done under this Act or the rules or regulations made thereunder. However, nothing in the Act exempts any person from any suit or other proceedings which might, apart from this Act, be brought against him.

### **Funding of firms in resolution**

**3.102** The extant legal framework does not provide for constitution of any resolution fund for use in resolving a failing financial institution, or for ex-post recovery of costs of providing temporary financing by the resolution authority to facilitate resolution.

**3.103** However, the DICGC Act, 1961 provides for setting up an ex-ante deposit insurance fund by the DICGC. The fund is primarily sourced out of the insurance premia collected from insured banks (commercial banks including branches of foreign banks, co-operative banks, and RRBs), repayments received, coupon received from investment in central government securities, etc. The fund does not provide insurance cover to the depositors of NBFCs. The fund is used to make payments to the depositors in cases of amalgamation, reconstruction, compromises, arrangements and liquidation. The deposit protection provided by DICGC does not give any priority/preference to depositors of any insured banks, including branches of foreign banks functioning in India. However, the depositor protection is not provided to depositors of foreign branches of Indian banks. Moreover, the existing set up of DICGC does not permit the use of deposit insurance fund to finance non-payout resolutions.

**3.104** 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.

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<sup>1</sup>Section 58A of RBI Act, 1934.

<sup>2</sup>Section 22 of IRDA Act, 1934.

## **Non-discrimination among creditors on the basis of nationality, location of claim etc.**

**3.105** 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. The depositor protection/ insurance is, however, not provided to depositors of foreign branches of Indian banks by DICGC. 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 regime 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.

**3.106** In terms of Section 11(4) of the BR Act, 1949, in the event of a foreign bank ceasing to carry on banking business in India, the minimum paid up capital and reserves which it is required to maintain under Section 11(2) of the Act *ibid* shall be an asset of that company on which the creditors of the company in India shall have first charge. This, however, talks only about the capital and reserves kept with the Reserve Bank. The proceeds from other assets have to be distributed as per the provisions of the Companies Act, which do not discriminate on the basis of nationality, location of claims or the jurisdiction where it is payable.

## **Information sharing and cross-border cooperation**

**3.107** There is no specific statutory provision enabling or prohibiting the Reserve Bank or the central government from cooperating with foreign resolution authorities. Further, Indian law does not specifically recognize foreign bankruptcy proceedings. However, Indian Courts on reciprocity basis recognize the decrees passed by the foreign courts, subject to the exemptions provided in Section 13 of the Code of Civil Procedure, 1908 ("CPC"). In terms of Section 44A of CPC, the certified copy of a decree passed by a foreign court of any reciprocating territory has to be filed in a District Court and such decree may be executed in India as if it had been passed by the District Court.

**3.108** Further, Section 45E of the RBI Act, 1934 prohibits the Reserve Bank or any banking company from disclosure of credit information, except in the following circumstances:

- (i) The disclosure by any banking company with the previous permission of the RBI of any information furnished to it under Section 45C;

- (ii) Publication by RBI of any information collected by it under Section 45C in such consolidated form as it may think fit without disclosing the name of any banking company or its borrowers in the public interest;
- (iii) The disclosure or publication by the banking company or RBI of any credit information to any other banking company or in accordance with the practice and usage customary among the bankers or as permitted or required under any other law; and
- (iv) Disclosure of any credit information under the Credit Information Companies (Regulation) Act, 2005.

**3.109** Presently, the RBI has been engaging in Memorandum of Understandings (MoUs) with various Central Banks with a view to promoting greater co-operation and sharing of supervisory information between the supervisors. So far, the Reserve Bank has signed 19 MoUs with regulators of various jurisdictions. However, the present approved MoU framework does not envisage/provide for cooperation, coordination and exchange of information between/amongst resolution authorities or for crisis resolution.

**3.110** IRDA has become a signatory to the Multilateral Memorandum of Understanding (MMOU) of International Association of Insurance Supervisors (IAIS) which provides an international platform for cooperation and sharing of information. The IRDA (Sharing of Confidential Information Concerning Domestic or Foreign Entity) Regulations, 2013 are in place, which provide for the manner in which/bodies with which confidential information can be shared. The MMOU with the IAIS also provides a framework for enhanced supervisory cooperation between the supervisory authorities and has also envisaged/provided for cooperation, coordination and exchange of information including in case of winding up, liquidation and bankruptcy and administration of guarantee funds.

**3.111** However, the present approved MoU framework for banks for enhanced supervisory cooperation between the domestic regulatory/supervisory authorities and foreign authorities, does not envisage/provide for cooperation, coordination and exchange of information between/amongst "resolution authorities" or on crisis resolution.

### **Recovery and Resolution Planning and Resolvability Assessments**

**3.112** Though there are various domestic financial institutions that could be considered as systemically important and that can impact the financial stability of the country, they are not mandated by the regulator or the supervisor to prepare recovery and resolution plans.

Moreover, presently, neither the respective regulators nor the central government assess and evaluate the feasibility and credibility of resolution strategies for Indian financial institutions. The assessment is also not conducted for the financial conglomerate/groups.

**3.113** However, the frameworks for “Regulation and Supervision of Financial Market Infrastructures regulated by RBI as well as by SEBI” have been issued in July 2013. Accordingly, all FMIIs have to comply with the Principles of Financial Market Infrastructures (PFMI), which includes putting in place a Recovery and Resolution Plan.

### **Crisis management groups and Institution-specific cross-border cooperation agreements**

**3.114** Presently, the Indian financial institutions do not qualify for classification as G-SIFIs. However, 15 of the 29 G-SIBs and eight out of thirteen Global Systemically Important Insurers (G-SIIs) have presence in India in the form of branches/joint ventures. The responsibility for constituting the CMGs for G-SIFIs lies with the home resolution authority. So far, no CMGs have been constituted by the Indian authorities in respect of financial institutions that have foreign presence. So far, India has not signed any cross-border cooperation agreements for resolution of G-SIFIs.

## **Problems in Financial Institutions in India**

### ***Problems in banks***

**3.115** In India, during the past decade nine commercial banks<sup>1</sup> were voluntarily amalgamated and five banks<sup>2</sup> were compulsorily amalgamated. There has been no case 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).

**3.116** Private sector banks that demonstrated signs of weakness were compulsorily amalgamated with other strong banks in a timely manner in order to protect the interests of

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<sup>1</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>2</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



depositors. However, these compulsory amalgamations took place only upon valuation and assessment by the transferee bank and did not involve any regulatory forbearance from RBI. The transferee banks took over the entire liabilities of the transferor bank, either on the assessed value or at a discount with the DICGC having to pay certain amount (in one case), or even made an upfront payment to the shareholders of the transferor bank (in one case). The compulsory amalgamations during the last decade have helped in avoiding liquidation of commercial banks that may have resulted in payments by DICGC and loss to the depositors. The resolution process adopted in respect of the above-mentioned five banks is given in brief in **Box 3.2**.

### BOX 3.2

#### Problems in banks in India – Use of resolution powers and tools

**The Benaras State Bank Ltd. (BSBL)**, a scheduled commercial bank with a network of 100 branches, had several deficiencies in the areas of credit management and funds/investment management. The bank's net worth had eroded and its CRAR had turned negative. In order to prevent any run on the bank, RBI issued directions under Section 35A of the B. R. Act, 1949 placing restrictions on the functioning of the bank. Meanwhile, the valuation of assets and liabilities of the bank was done by an independent firm of Chartered Accountants. The valuation ascertained the pro rata share at 85.85% and eligible depositors' accounts were credited with a sum equal to 85.85% of the value of their deposits. The DICGC had to settle the claims to the extent of ₹ 99.00 crore on amalgamation of the bank. Finally, in terms of Government notification, Benares State Bank Ltd. (BSBL) was amalgamated with Bank of Baroda on June 19, 2002. While in the resolution process, there was no regulatory forbearance granted to the transferee bank, there was no loss to the depositors and the employees of the transferor bank. However, the shareholders of the transferor bank suffered the loss.

**The Nedungadi Bank Ltd.**, a scheduled commercial bank with a network of 171 branches, was engaged in 'arbitrage trading in shares' through three broking firms, which envisaged simultaneous purchase and sale of shares on different stock exchanges to take advantage of the price difference. With the stock market crash in 2000 and high level of NPAs (gross NPA and net NPA at 41.3% and 26.0% respectively), the bank's CRAR and net worth turned negative as on September 30, 2001 at (-) 5.63% and (-) ₹ 45.56 crore respectively. The Chairman of the bank, being the approving authority for all such transactions, was removed by the RBI in terms of Section 36AA of BR Act, 1949, and a new Chairman was appointed. The assessment of the provisional results revealed a requirement of fresh infusion of capital of ₹ 112 crore and ₹ 170 crore to cleanse the balance sheet. Considering the bank's adverse financial position, it was considered doubtful of raising capital by a public issue, as well as the feasibility of voluntary merger. Finally, the RBI recommended to the central government for placing the bank under moratorium, and was amalgamated with Punjab National Bank with effect from February 1, 2003. This resolution process did not envisage any loss to the depositors and the employees of the bank, as also did not involve DICGC participation. The process did not provide any regulatory forbearance to the transferee bank, but the shareholders of the transferor bank suffered the losses.

**The Global Trust Bank Ltd. (GTB)**, a scheduled commercial bank with a network of 104 branches, had a very high capital market exposure and high level of NPAs. Noticing an unusual rise in share price (34.86%) of GTB as compared to bank index (4.78%) and BSE Sensex (5.4%), RBI requested

SEBI in November 2000 to make detailed enquiries. Quick scrutiny by RBI revealed various deficiencies in capital market exposure, NPA and CRAR. The bank was put under monthly monitoring and was asked to draw up action plan to bring improvements in its functioning within a time frame of six months. The bank was also asked to submit a concrete time bound action plan to reduce its exposure to capital market to 5% by March 31, 2002. As directed by BFS, RBI undertook, through auditors, an independent assessment of quality of assets and determine true financial position. On the basis of the assessment, the bank was issued a set of directions relating to lending, declaration of dividend, capital market exposure, etc. Due to non-improvement and further deterioration of bank's financial position, RBI placed the bank under moratorium and was finally merged with Oriental Bank of Commerce (OBC) in terms of Section 45 of BR Act, 1949. The merger was kind of a private sector purchase by OBC and there was no loss to the insured depositors as well as employees of the transferor bank and no involvement of DICGC insurance fund.

**Ganesh Bank of Kurundwad Ltd.**, a scheduled commercial bank with a network of 32 branches, had very low capital base with high NPA level and negative networth. The bank was initially put under monthly monitoring system and subsequently was advised to take structured actions under Prompt Corrective Action (PCA) framework as its NPA had hit the trigger point of above 10%. With signs of weaknesses in the bank's financials in terms of high gross NPA and negative networth, the RBI placed the bank under Moratorium for a period of 3 months and prepared a draft Scheme of Amalgamation of Ganesh Bank of Kurundwad Ltd. with the Federal Bank Ltd. which had forwarded its expression of interest and sought no regulatory forbearance on amalgamation. However, due to court cases and litigations, the amalgamation could not be effected on the Government notified date. On resolution of the court cases, the bank was finally amalgamated with Federal Bank Ltd on January 24, 2006. This process of amalgamation, though did not envisage any loss either to the insured depositors and employees of the transferor bank and to the DICGC Insurance Fund, indicated a requirement of a special resolution regime for banks with sufficient tools and powers to the resolution authority and without the court process and shareholders' approval.

**United Western Bank Ltd.**, a scheduled commercial bank with a network of 230 branches, had poor financials in various parameters such as, negative CRAR, high level of NPAs, high cost deposits, etc. Accordingly, the bank was placed under monthly monitoring. With no improvement in the bank's financials inspite of close monitoring and issuing of directions, and unsuccessful raising of capital through rights issue, RBI applied to the Central Government for placing the bank under moratorium and prepared a scheme of amalgamation. Among the various Expressions of Interest (EOIs) received, IDBI Bank Limited's proposal was accepted as the proposal provided for payment to depositors in full, it did not seek any regulatory forbearance and provided for an upfront payment of ₹ 28 per share to the transferor bank's shareholders. The bank was finally amalgamated with IDBI Bank Ltd. on October 3, 2006.

### ***Problems in insurance companies***

**3.117** Post opening up of the insurance sector to private participation in 1999, there have been no instances of failure of an insurance company in India. There have, however, been instances where the regulator (IRDA) has intervened to address industry wide/individual company related concerns which could have had implications for the industry as a whole given the nascent stage of the industry and the concerns for the health of the industry.

**3.118** Until May 2013, insurers were permitted to have representative/liaison offices outside India. Exception to this requirement was public sector insurers that had presence in foreign

countries in the nationalized set up, prior to the opening up of the sector in 1999. Effective from May 2013, Indian insurance companies are permitted to open foreign insurance company (including branch office) outside India. Simultaneously, Section 34G of the Insurance Act, 1938, empowers IRDA to order for closure of any branch outside India of an insurer if it has reason to believe that the working of that branch is generally resulting in a loss or that the affairs of that branch are being conducted in a manner prejudicial to the interests of the policy-holders or the public interest within such period, not being less than one year. The IRDA is also empowered to intervene, where considered necessary to address a deteriorating portfolio of business. Brief of two cases of problems in insurance sector are provided in **Box 3.3**.

### **BOX 3.3**

#### **Problems in insurance companies in India – Use of resolution powers**

##### **National Insurance Company Ltd. – Hong Kong Branch**

The National Insurance Company (NIC), the oldest insurance company in India incorporated in 1906, started functioning as a subsidiary of the General Insurance Corporation of India from 1972 when its services were dedicated to the nation by the General Insurance Business Nationalisation Act. The NIC, till 2002, had operations in two foreign markets (Nepal and Hong Kong) through local branches. In Hong Kong, business came mainly from Motor and Extended Coverage/Employer Liability Policies, where chances of occurrence of losses are comparatively more than other types of insurance business. The Hong Kong branch posted net losses for the years 2001-02 and 2002-03. Consequently, it had stopped accepting new insurance business in Hong Kong with effect from February 18, 2002. However, the branch continued servicing the policies in force. The operations were discontinued and went into run-off portfolio to facilitate settlement of liabilities. The run-off operations were handed over to New India General Insurance Company Ltd. through creation of an escrow account. The arrangement continued as a pure run-off operation until the entire outstanding liability was paid off.

##### **AMP Sanmar Life Insurance Company Ltd.**

AMP Limited of Australia and Sanmar Group, formed a joint venture to carry on life insurance business in India. AMP Sanmar Life Insurance Company Ltd., was granted registration by the Authority to undertake life insurance business on 3<sup>rd</sup> January, 2002. The company commenced underwriting policies in a small way in the financial year 2001-02 with first year premium of Rs.27.73 lakh going up to Rs.91.33 crore in 2004-05. Following AMP's decision to stay focused on its core wealth management business in Australia and New Zealand and keep its Asian focus centred in asset management through AMP Capital investors, AMP Limited decided to sell its stake in the joint venture and concurrently Sanmar decided to take advantage of the opportunity to review its stake in the business.

When the IRDA was apprised of the intent of the promoters to effect changes in the ownership structure for obtaining necessary permission, the prime concern of the regulator was to ensure that the interests of policyholders continues to be protected and all the extant commitments made by the company continues to be honoured in the normal course despite ownership changes. It was also clear that the process of change in ownership would necessarily involve a time lag during which various options for the restructuring of the company had to be explored to the satisfaction of all concerned. The company was asked by IRDA to establish regular weekly reporting systems to closely monitor the

developments to safeguard the interests of the policyholders. Restrictions were placed on major expenses and in particular on capital expenditure, changes in the Board of Directors and on the various committees of the Board, and any measures which could possibly weaken the company. The management was not permitted to take any policy decision which could have ramifications on the functioning of the company without the explicit concurrence of the IRDA.

Though in the initial few days after the announcement by the insurance company, there was a noticeable uptrend in redemptions combined with a slow down in the new premium underwritten, the anxiety of policyholder on the future of the company reduced after the IRDA assured through the media that the interests of the policyholders would be fully protected as the company was compliant with the stipulations on solvency requirements.

Since the process of amalgamation as laid down in the Act was long drawn, the IRDA pursued with the owners other options to ensure that the identity of the insurance company was retained and those parties which were interested in acquiring the stake of the promoters could be short listed.

Consequently the promoters entered into an agreement on 31<sup>st</sup> July, 2005 for sale of their 100 per cent holdings to Reliance Capital Ltd. (RCL) and sought regulatory approval for the proposal. The Authority carried out the due diligence of RCL, a Non-Banking Finance Company (NBFC) registered with the Reserve Bank of India (RBI), in consultation with other regulators and looked specially into the capability of the company to carry life insurance business, its ability to honour all the commitments made to the policyholders and to inject funds at periodic intervals to meet the requirements of capital funds. On being satisfied the IRDA granted approval to the transfer of shares on 29<sup>th</sup> September, 2005. The new promoters affirmed, through the media, their commitment to honour all policyholders' contracts and the insurer continued its normal activity without any restrictions thereafter.

## 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

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<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

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<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.

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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*

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<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.

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<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

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<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

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<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

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<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*

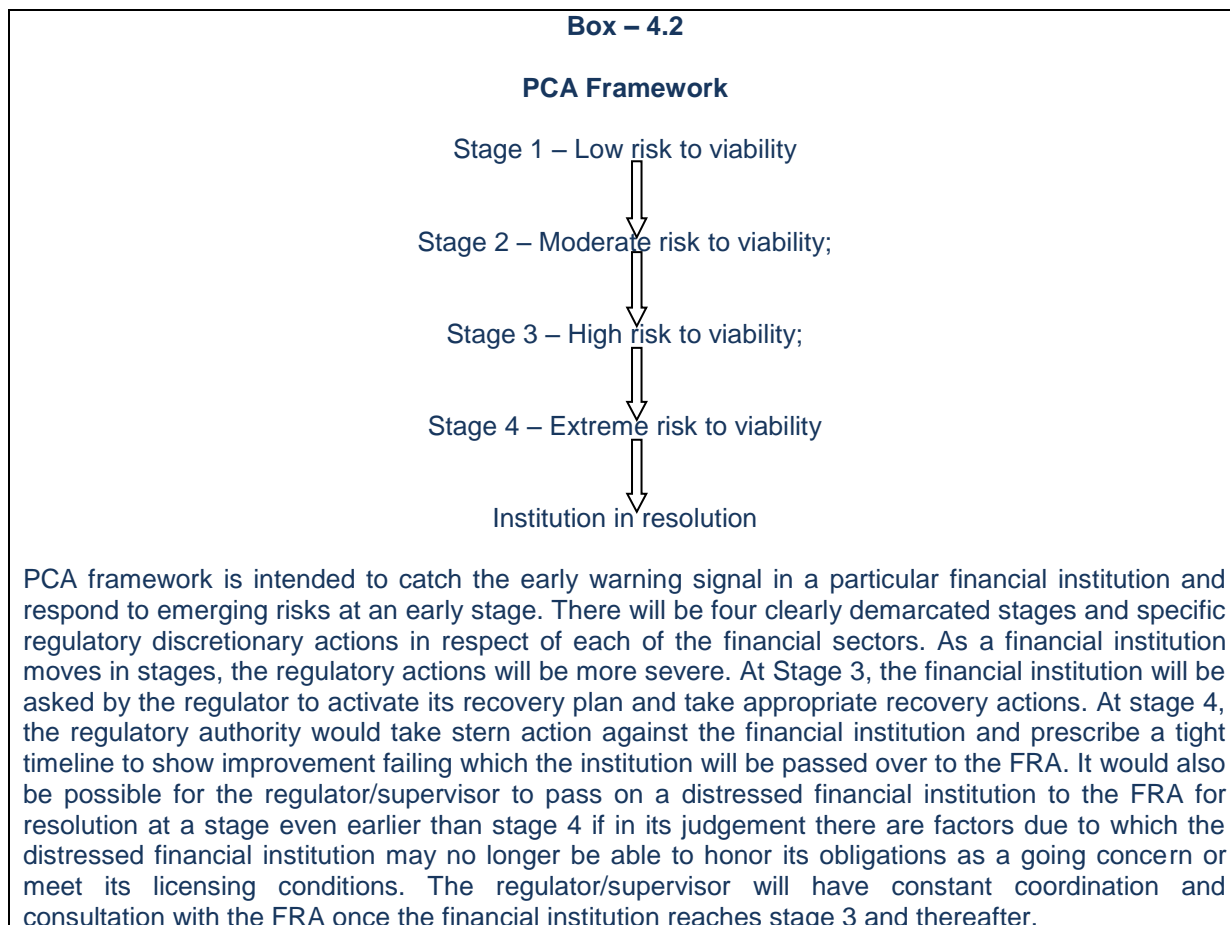
*envisaged a framework of “prompt corrective action” incorporating a series of intervention measures to be undertaken by the micro-prudential regulators and the resolution corporation to restore the financial health of the covered service providers. This would ensure enhanced regulatory intervention 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:

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<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

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<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.

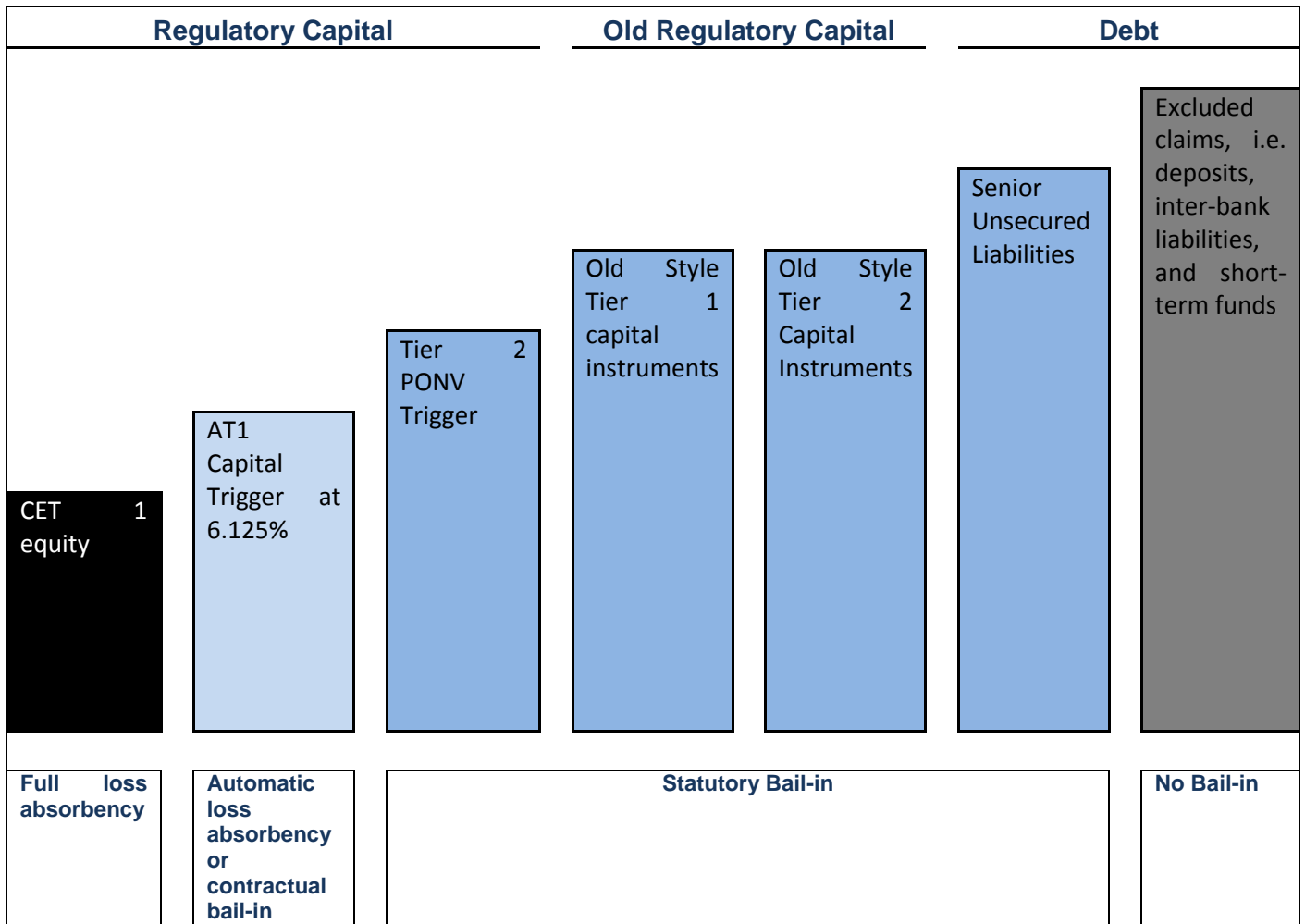
**4.91** As bail-in allows the resolution authorities greater flexibility in their response to the failure of large and systemically important financial institutions (SIFIs) in restoring viability and disincentivize becoming “too-big-to-fail”, the Group recommends taking into account all factors, adopting 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 requires 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.

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<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

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<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*

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<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.

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<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.

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<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

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<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

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<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

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<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[Purchase and Assumption tool - Sale of whole or part to private sector purchaser]     A --&gt; C[Bridge bank tool]     A --&gt; D[Good-bank and bad-bank tool]     C --&gt; E[Sale of bridge bank to private sector purchaser]     D --&gt; F([Good Bank])     D --&gt; G([Bad])     F --&gt; H[Sale to private sector]     G --&gt; I[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

## CHAPTER 5

### Cross-border Cooperation, Coordination and Information Sharing

*The FSB Key Attributes have underscored the importance of cross-border cooperation and coordination among the relevant authorities in different jurisdictions for orderly resolution of financial institutions with cross-border operations. Accordingly, the FSB Key Attributes recommend a framework for overcoming the national legal hindrances, barriers and obstacles and to improve the effectiveness of cross-border resolution measures. The resolution authority should be empowered to achieve a cooperative solution with foreign resolution authorities. The legal framework should not provide for unilateral action by the host jurisdiction as a result of official intervention or initiation of resolution actions in home or other jurisdictions. Recognizing the importance of appropriate exchange of information between relevant authorities for cross-border resolution of large and systemically important financial institutions, the key attributes provide for addressing and removing the legal, regulatory or policy impediments to information sharing, while ensuring the confidentiality and protection of sensitive data.*

**5.1** Financial conglomerates and large and complex globally active financial groups dominate the financial landscape in various countries. These institutions not only transcend national boundaries but also cross over the traditional business lines. The activities of these groups have expanded beyond traditional deposit-taking and lending to include a range of non-bank financial activities, encompassing securities, insurance, funds and asset management. In addition, these global systemically important financial institutions (G-SIFIs) also act as systemically important nodes within a globalized market for capital. The development of these institutions has been spurred by financial liberalization, increased competition in the financial industry, search for yield, development of new financial instruments and techniques for transfer of risk, economies of scale in terms of product offerings and services, and the removal of barriers to cross-functional and cross-border mergers and acquisitions.

**5.2** Global integration and greater efficiency do not necessarily guarantee greater financial stability. Larger financial institutions may have a greater capacity to withstand stress; their operations are more diversified; they tend to have more sophisticated risk management capabilities and they have bigger capital cushions. Yet, they pose the risk of transferring shocks from one corner of the world to another in the event that they encounter financial distress due to unforeseeable economic shocks, risky business models, mismanagement, or fraud.

**5.3** The recent global financial crisis has shown that the complexity of the corporate structure of most international financial conglomerates is in itself a significant source of risk. The failure of a large and complex financial institution can cause widespread damage to financial sector in more than one jurisdiction. Since most of these institutions are managed in an integrated fashion along business lines with only minimal regard for legal entities, national borders or functional regulatory domains, mapping of an institution's business activities into its legal entities presents a formidable challenge. Moreover, these legal entities would be subject to scores of different national regulatory and resolution mechanisms, which will not be harmonised. This was clearly evident in the 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.

**5.4** Whatever may be the powers available to a resolution authority, there are inherent difficulties in cross-border resolution of financial institutions, making it practically impossible to resolve them smoothly. Even among the Benelux countries, what started out as a cooperative effort to recapitalize Fortis, ended up in a strife as each country attempted to protect its own national interest. In the case of Icelandic banks, the UK resorted to the use of anti-terrorist legislation to protect the interests of UK depositors, which was against the norms followed by the members of European Economic Area (EEA).

## Challenges in Crisis Resolution

**5.5** The recent financial crisis illustrated the limitations of the national resolution regimes to resolve financial institutions that are global in nature. Mervyn King, former Governor of Bank of England, said that the large financial groups have been '*international in life, but national in death*'. This was amply demonstrated in many of the financial institutions' failures during the global financial crisis that suffered due to the absence of a cross-border crisis management framework.

**5.6** The various obstacles to the ability of the home and host authorities to cooperate in the resolution of the G-SIFIs amplified the recent crisis. Given the fact that resolution is itself highly complex and cannot be achieved by mechanically applying pre-defined resolution tools, it is recognized that resolution of financial institutions across the boundaries is even harder to achieve. The barriers and challenges in effecting orderly resolution of G-SIFIs can be observed in the relatively simple resolution of Bank of Credit and Commerce International (Overseas) Limited [BCCI], which also had presence in India in the form of a single branch(**Box 5.1**).

#### **BOX 5.1**

##### **Resolution of Bank of Credit and Commerce International (Overseas) Limited**

Bank of Credit and Commerce International (Overseas) Limited (BCCI) was a foreign bank incorporated in Grand Cayman Islands. The bank had presence in India in the form of a single branch at Bombay. On surfacing of viability problems, the bank was placed under control of a receiver (Mr. Ian Wight), appointed by the Governor of the Cayman Islands by an order dated 5th July, 1991 under Section 18 of the Bankruptcy Law as applicable in the Cayman Islands. The said order directed and authorized the appointed Receiver to take charge of the properties of the BCCI wherever situated.

On 6th July, 1991, the Manager-in-charge of BCCI, Bombay was advised by its head office to suspend all payments and other banking transactions. The Manager-in-charge of BCCI in Bombay forwarded a copy of the same to RBI. On receipt of information from BCCI, Bombay and also from the Provisional Liquidators of the UK Branches of BCCI, the Reserve Bank issued directives to BCCI, Bombay to safeguard the interests of the local depositors and also filed a petition before the Bombay High Court (BHC) on 15th July, 1991 under Section 38 (3) of the Banking Regulation Act, 1949 (BR Act) read with Companies Act, 1956 for winding up of BCCI, Bombay and appointment of State Bank of India, Central Office, Bombay as liquidator.

The High Court on 15th July, 1991, as an interim measure, appointed SBI as Provisional Liquidators in respect of the assets of BCCI in Bombay, which was confirmed by the court on 22nd January, 1992. On 14th January, 1992, the Grant Court of the Cayman Islands confirmed its ad-interim order of 5th July, 1991.

On 22nd January, 1992, the Bombay High Court, after hearing the concerned parties including the Joint Provisional Liquidators of BCCI, appointed by the Court of Cayman Islands, confirmed its ad-interim order dated 15th July, 1991 appointing SBI as Provisional Liquidators of BCCI, Bombay branch. Consequently, all the business activities of BCCI Bombay branch was suspended.

On 16th January, 1992, a Memorandum of Understanding (MoU) was entered into between the said Official Liquidator and RBI for disposal of the Bombay branch of BCCI, whereunder it was agreed that BCCI Bombay branch be sold to one of the buyers to be appointed by the RBI. The purchaser was to assume full responsibility of both the depositors and creditors, including the liabilities of the staff, so also all other existing as also future liabilities of BCCI, Bombay branch. Another option under the MoU was to sell the branch to SBI and/or its subsidiary in accordance with the law. The High Court approved the arrangement by its order dated February 22, 1992.

On approval by Bombay High Court, the RBI held negotiations with all concerned including Official Liquidators, Cayman Islands. The Joint Official Liquidators invited offers for sale of the undertaking of the Bombay branch of BCCI to which SBI responded and submitted its offer. The offer of SBI was accepted by Official Liquidators, Cayman Islands and also got the approval from the Court of Granting Cayman for the sale. This was communicated by fax on February 24, 1993.

The Bombay High Court, accepting the offer of SBI for the purchase of BCCI Bombay branch as a going concern, gave directions for safeguarding the interest and claims of all concerned. This was

taken over by a subsidiary of SBI (SBICL). The High Court passed its final order on November 12, 1993 confirming the action.

### *Supervisory responsibility*

**5.7** The Basel Accord governs the supervisory responsibilities of the home and host country of the parent of a banking group and its subsidiary respectively. The Accord entrusts the responsibility of supervision of the group on a consolidated basis to the home country supervisor (of the parent), while the host country supervisor is responsible for subsidiaries authorized in the host country. Further, the Accord provides that the responsibility for the supervision of the branch with respect to solvency resides primarily with the home supervisor. However, the responsibility with respect to the supervision of liquidity resides with the host supervisor.

**5.8** This division of supervisory responsibility between the home and host country supervisors may not necessarily be consistent with the division of responsibilities relating to crisis management and resolution.

### *Misalignment of incentives of different national regulators*

**5.9** In the case of problems in a G-SIFI and in the absence of effective cross border resolution framework, each of the national authorities will act in accordance with its own statutory obligations. The priorities of national supervisors and resolution authorities are financial stability within their own jurisdiction as also protection of interests of national creditors, depositors and taxpayers. Thus, the obligation to protect local markets and local creditors' interests (ring fencing) will take precedence over a more global perspective encompassing markets and creditors in other countries. There is, therefore, a high risk that the resolution procedure will be highly influenced by national interests. Moreover, the losses incurred by the creditors will not be uniform between jurisdictions. This is a central concern that lies behind moves towards ring-fencing and territorial approaches.

**5.10** Such problems have led to host countries' inclination towards a "subsidiarization" solution for local branches under which the local subsidiary is required to maintain sufficient capital and follow other prudential norms including sufficient assets to cover its liabilities. The UK had suggested such an approach under the label of "ring fencing" in the wake of 2007/2008 crisis.

### *National resolution frameworks*

**5.11** While international financial groups operate globally, the frameworks for addressing their distress and failure are local and apply to distinct parts of the group rather than to the group as a whole. Moreover, resolution frameworks are established by national laws and are enforceable only in respect of those institutions or branches of institutions operating in the national territory. In the absence of international legal framework, the resolutions of such financial groups are subject to different national frameworks that do not recognize the law of other jurisdictions. FSB has made some progress in setting standards for cross-border resolution, the implementation of which will pose challenges in modifying national regimes and their success will depend on *quid pro quo* from other countries.

**5.12** Further, differences between home and host insolvency regimes, untested enforceability of netting and collateral arrangements, depositor/insurance policyholder/investor protection legislation, ring fencing practices, and the imposition of governmental or judicial measures, such as moratoria, receivership measures, and financial sanctions, introduce significant uncertainty that makes it difficult to plan a resolution measure or wind down in a cross-border context. Depending on the location of the assets and determination of the applicable law, different rules will apply with respect to preference, ownership interests and set-off.

### *Informational asymmetries and regulatory competition*

**5.13** Effective crisis management requires access to timely, accurate and relevant information about the G-SIFI and its operations. The usefulness of the information depends on how quickly it can be obtained and how up-to-date it is. In a crisis, if particular types of information can help to achieve a solution that is more advantageous for the domestic jurisdiction, the regulator or the supervisor may not be inclined to share that information with the foreign authorities.

**5.14** The legal frameworks of many jurisdictions do not sufficiently facilitate coordination and do not empower their supervisors or the relevant resolution authority to share information with their counterparts in other jurisdictions. Some countries address information sharing only during the normal times of supervision. They do not clearly differentiate the provisions or arrangements in place for information sharing in crisis situation. Moreover, some authorities do not have a clear authority for, or are prevented by law from sharing information directly with a foreign authority other than with a supervisor restricted for supervisory purposes. Moreover, even if the information is obtained, there are restrictions or



requirements as to the approval of the authority that furnished information, for onward disclosure of information.

### *Complexity of group structures*

**5.15** The operation of large international group structure in multiple jurisdictions and their internal and external exposures and relationships creates opaqueness in the risk exposures and also makes crisis resolution difficult and costly. Further, the complexity of the business model and/or the financial products provided by an institution contributes to its systemic relevance, as it renders it very difficult for the market participants to assess the impact and the outcome of a crisis situation.

## **Need for Cooperation and Coordination**

**5.16** Establishment of an international treaty that would obligate countries to defer to the resolution decisions of the jurisdiction where the financial institution or group has its main activities does not seem practically feasible. An effective framework for resolution of cross-border financial group would therefore, require enhanced cooperation and coordination among resolution authorities and harmonization of methods for achieving equitable cross-border outcomes based on legally effective crisis management agreements. Such crisis management agreements need to be embedded in the national resolution frameworks incorporating a number of provisions designed to underpin and support the international market in financial services.

**5.17** A suitable framework for enhanced cooperation and coordination will essentially involve amendment to existing national laws so as to enable national authorities to coordinate resolution efforts with their counterparts in other jurisdictions to the maximum extent consistent with the interests of creditors and domestic financial stability. In such a framework, the national authorities would continue to retain the discretion to act independently, if in their judgment such action is more consistent with these objectives. Enhanced coordination mechanism will be substantiated between those countries that have sufficiently aligned resolution frameworks and rules (i.e., non-discrimination against foreign creditors, appropriate and similar resolution tools, appropriate creditor safeguards, and robust rules on depositor, policyholder and investor preference, etc.), robust supervisory frameworks and institutional capacity to reorganize and implement an international solution.

**5.18** Considering the legal hindrances, barriers and obstacles indicated above, the FSB has sought to improve the cross-border effectiveness of resolution measures by specifying

certain key attributes that the jurisdictions should follow. For this to work, both the home and host authorities must have the requisite powers and regimes for application of resolution measures not only to domestically incorporated financial institutions but to domestic branches of foreign institutions, and to assets, liabilities and contracts of foreign institutions located within a jurisdiction. At the minimum, this would require the authorities to be legally empowered with the capacity to cooperate with the foreign resolution authorities.

#### *Statutory mandates to foster cross-border cooperation*

**5.19** The FSB has suggested that in order to achieve orderly resolution of financial institution with presence in multiple jurisdictions, the resolution authorities should be mandated statutorily with the powers to act for achieving a cooperative solution with foreign resolution authorities. The legal framework or the regulatory norms in a particular jurisdiction should not provide for triggering of unilateral action in a jurisdiction on initiation of any resolution or insolvency proceedings or any official intervention in another jurisdiction. On the other hand, the statute should provide for extension of the perimeter of resolution powers of the resolution authority, in addition to the locally incorporated financial institutions, to the local branches of foreign institutions and to use its powers either to support a resolution carried out by a foreign home authority or to take measures on its own initiative.

**5.20** In the absence of effective cross-border cooperation and information sharing or in the event of inaction or inappropriate action by the foreign home authority, the statutory framework should provide the right to the resolution authority for taking discretionary national action on its own initiative, if considered necessary, to achieve financial stability. In case of exercise of discretionary national resolution action by the host resolution authority, they should have the capacity through cooperative arrangements for consultation with the foreign home authority to assess the impact of resolution action on financial stability in other jurisdictions. In case of exercise/application of resolution powers to individual components of a financial group, the resolution authority needs to take into account the impact on the group as a whole. The host authority should also have the capacity to give prior notice of discretionary national action in relation to the local branch of a foreign bank, to a foreign home resolution authority.

**5.21** The practice of having legal framework mandating the national authorities to seek cross-border cooperation with foreign authorities for the purpose of crisis resolution is practically uncommon in most of the jurisdictions. However, eight jurisdictions<sup>1</sup> have

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<sup>1</sup>Australia, Hong Kong, Indonesia, Japan, Spain, Switzerland, UK and US.

statutory provisions that explicitly empower or strongly encourage resolution authorities to cooperate with foreign authorities.

**5.22** The Working Group noted that though the Indian banks or other financial institutions do not qualify as G-SIFIs, 15 out of 29 G-SIBs identified in November 2013 have operational presence in India in the form of branches<sup>1</sup>. The foreign insurance companies also have presence in India but in the form of joint ventures<sup>2</sup>. On the other hand, the Indian financial institutions (banks as well as insurance companies) though mostly national in nature, do have presence in other jurisdictions in the form of branches and/or subsidiaries. However, the share of international assets as a percentage of total consolidated assets of such financial institutions is very low.

**5.23** *The FSLRC is of the view that an un-coordinated approach by the home and host countries' authorities would create difficulties in resolution of cross-border SIFIs in a manner that protects interests of consumers and prevents the risk of contagion. The Commission has also recognized the on-going deliberations in this area at international policy forums. It has suggested that India must participate in emerging global arrangements on cross-border resolution. The Commission has, however, recommended setting up of a Committee, five years from now (2013), to review the emerging consensus in this field and suggest amendments in the legal framework on resolution accordingly.*

**5.24** The group recognizes that there are challenges in cross-border coordination and cooperation due to separate national mandates, legal frameworks, priorities, etc., and internationally work is in progress on information sharing arrangements for resolution purposes, development of data template for information sharing, norms for cooperation, coordination among the non-CMG host jurisdictions, etc. **Keeping in view plausible opening up of the Indian financial system in future and Indian financial institutions becoming G-SIFIs with large scale cross-border operations, the Group recommends that the proposed legislation for resolution regime for financial institutions should**

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<sup>1</sup> Among the foreign banks, Standard Chartered Bank with 101 branches has the largest presence in India in terms of outreach, followed by HSBC Ltd. with 50 branches, Citibank N.A. with 42 branches, The Royal Bank of Scotland N.V. with 31 branches, Deutsche Bank with 18 branches, BNP Paribas with 8 branches, Barclays Bank Plc. with 7 branches, Credit Agricole Corporate & Investment Bank and Bank of America with 5 branches each, The Bank of Tokyo-Mitsubishi UFJ Ltd. with 4 branches, Societe Generale with 3 branches, Mizuho Corporate Bank Ltd. with 2 branches, UBS AG, JP Morgan Chase Bank N.A. and Sumitomo Mitsui Banking Corporation with one branch each.

<sup>2</sup> Foreign insurance entities are not permitted to set up branch operations in India. However, almost all G-SIBs have domestic presence in India in the form of joint ventures with holding of 26% equity in insurance companies.

**enable the FRA to achieve cooperative solution with foreign resolution authorities.  
(Recommendation 37)**

*Recognition to foreign resolution measures*

**5.25** Generally, the resolution tools/options adopted by the home resolution authority in order to achieve an orderly resolution of a financial institution, will not have an automatic effect in the host jurisdiction. Most of these actions could involve court proceedings that may not be timely for effective resolution. In order to reduce or remove the legal, regulatory or policy impediments that hinder conduct of effective resolution, the FSB has suggested that jurisdictions should have transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority.

**5.26** Such a process would enable the home authority to gain rapid control over the financial institution or its assets that are located in the host jurisdiction, in cases where the institution is being resolved under the law of the home jurisdiction. It stands to reason that recognition or support of the foreign measures should be provided only when the home authority extends equitable treatment to the creditors in the host country in the foreign resolution proceedings.

**5.27** So far, only the Swiss Resolution Authority (i.e., Swiss Financial Market Supervisory Authority (FINMA)) is vested with the exclusive authority to recognize foreign insolvency decrees and resolution measures that seek control over assets and operations of foreign financial institutions in Switzerland. Swiss FINMA has the power to recognize resolution measures ordered by a foreign authority. A condition for recognition is the equitable treatment of creditors in Switzerland, taking into account the statutory preferences they enjoy under Swiss law. The scope of the recognition is fairly broad and covers any type of restructuring or resolution measures, including a compulsory debt-to-equity conversion (“bail-in”) or order transferring assets, liabilities and contracts of the failed institution to a bridge bank. FINMA can also give recognition to administrators or liquidators appointed by a foreign resolution authority. Alternatively, FINMA can resolve a branch of a foreign financial institution independently under its sole authority.

**5.28** Presently, the legal framework permits the Reserve Bank of India and/or the Government of India to initiate resolution actions in case of any incipient problems in the

foreign bank branches situated in India. For all practical purposes, for regulation as well as resolution, they are treated on par with private sector banks. However, the provisions contained in the Banking Regulation Act, 1949 provide for a ring-fencing clause<sup>1</sup> in case of foreign banks operating in India.

**5.29** Indian law also does not specifically recognize foreign bankruptcy proceedings though Indian Courts on reciprocity basis to honour the decrees passed by the foreign courts, subject to the exemptions provided in Section 13 of the Code of Civil Procedure, 1908 (CPC). In terms of Section 44A of CPC, the certified copy of a decree passed by a foreign court of any reciprocating territory has to be filed in a District Court and such decree may be executed in India as if it had been passed by the District Court. As regards supporting the resolution carried out by a foreign home authority, Indian insolvency laws neither have any extra-territorial jurisdiction, nor do they recognize the jurisdiction of foreign courts in respect of the branches of foreign banks operating in India.

**5.30** Since the stake involved is very high and could have serious implications on the financial stability of host countries, the Group is of the view that in absence of a binding ex-ante agreement or international legal structure, any cooperation and coordination, no matter how well it starts out, is most likely to fail in a real resolution scenario. There is, therefore, a need to wait for the experiences gained in different jurisdictions.

## **Access to Information and Information Sharing**

**5.31** For making appropriate decisions and implementing an effective action plan when resolution is imminent, the resolution authorities would not only require the provision of up-to-date information on the business operations, structures and critical economic functions but also detailed resolution analysis prepared by the affected financial institution. Such information and analysis will enable them to choose the resolution option under current laws and regulations. Moreover, in case of cross-border firms, the authorities would need additional information on the legal and regulatory frameworks in which the firm 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.

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<sup>1</sup> According to Section 11(4) of BR Act, 1949, in the event of a foreign bank ceasing to carry on banking business in India, the minimum paid up capital and reserves which it is required to maintain under Section 11(2) of that Act shall be an asset of that company on which the creditors of the company in India shall have first charge.

**5.32** The Key Attributes provide that the resolution authority should have legal capacity, subject to adequate confidentiality requirements and protections for sensitive data, to share information, including RRP, pertaining to the group as a whole or the individual subsidiaries or branches, with the relevant foreign authorities for the sole purpose of preparation of RRP for the financial group as a whole or for implementing a coordinated resolution. This would mean sharing of information with the foreign supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes, not only in normal times but also in crisis situations. Such information sharing should be both at a domestic and cross-border level.

**5.33** The financial crisis has demonstrated that the absence of a process of coordinated resolution of legal entities in a financial group/conglomerate limits the option available to home or host country authorities for managing the problem in an orderly manner. The different regulatory and supervisory rules along with different accounting standards, liquidity requirements and regulatory objectives that apply to different legal entities of a financial group, potentially complicate resolution of domestic financial groups. This becomes more critical in case of cross-border financial groups in view of other challenges and obstacles.

**5.34** While the regulators/supervisors have been engaging in Memorandum of Understandings (MoUs)<sup>1</sup> with other jurisdictions' authorities, such as the Central Banks and respective financial sector regulators/supervisors with a view to promoting greater co-operation and sharing of supervisory information between the supervisors, there still lies a gap in coordination and information sharing for crisis resolution. They may not be legally enforceable and do not indicate how supervisors might cooperate in actual crisis.

**5.35** However, existing national legal and supervisory arrangements are not designed to coordinate the resolution of problems in all of the significant legal entities of a financial group. Insolvency rules apply on a legal entity basis and may differ depending on the types of businesses within the financial group. There are, however, exceptions to this in some jurisdictions. In a crisis, there could be a need to exchange information across different authorities domestically as well as with the foreign authorities. This cannot happen without strong cooperation mechanism.

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<sup>1</sup> Reserve Bank of India has so far entered into MoUs with 19 jurisdictions for supervisory coordination and information sharing. IRDA has entered into a Multilateral Memorandum of Understanding with the IAIS, which provides an international platform for cooperation and sharing of supervisory information between regulators subject to confidentiality stipulations.

**5.36** The objective of cooperation and information sharing among the domestic authorities in case of a domestic financial group may vary from cross-border financial group. In absence of cooperation among the various domestic regulators/supervisors and resolution authority as well as the institutions providing protection to depositors, insurance policyholders and investors, there is probability of spillover of problem in one legal entity of a group to the other due to contagion and reputation risk. Moreover, in case of a cross-border financial group, where the host country authorities are unable to obtain information from the home authorities would in all probability be more inclined to take action to protect local creditors and thus ring-fence assets. Better cooperation and information sharing can reduce the need for ring fencing.

**5.37** The Group has suggested earlier (in Chapter 4) a data template for submission of information by the financial institutions, on an on-going basis, to the financial resolution authority (FRA) and the regulators/supervisors for resolution planning and assessment of their resolvability and also institution of FDMC for on-line collection of financial data from all financial institutions. In addition, the Group has also suggested earlier (in Chapter 4) for entering into a MoU between the regulators/supervisors and FRA for effective and constant information sharing. This mechanism will ensure information sharing among the domestic authorities. The existing legal framework, however, restricts the domestic financial institutions and/or the regulatory authorities from disclosure of customer related non-public information. For example, Section 45E of the RBI Act, 1934 prohibits the RBI or any banking company from disclosure of credit information, except in certain circumstances, viz. the disclosure by any banking company with the previous permission of the Reserve Bank of India of any information furnished to the RBI, publication by RBI of any information collected by it in such consolidated form<sup>1</sup> as it may think fit without disclosing the name of any banking company or its borrowers in the public interest, the disclosure or publication by the banking company or RBI of any credit information to any other banking company or in accordance with the practice and usage customary among the bankers or as permitted or required under any other law and the disclosure of any credit information under the Credit Information Companies (Regulation) Act, 2005.

**5.38** While work in the area of cross-border information sharing is underway, which is being enhanced by the FSB through Resolution Steering Group, the Group recommends that the resolution framework in India should enable the FRA to share non-public information of Indian financial institutions with foreign home/host

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<sup>1</sup> Section 45C of RBI Act, 1934.

**resolution authorities on reciprocal basis and subject to confidentiality requirements and protection for sensitivity. (Recommendation 38)**

### *Supervisory Colleges*

**5.39** Supervisory colleges as a form of supervisory tool for information sharing are operational in many jurisdictions. The primary objective of a supervisory college is to assess and develop an understanding of the risk profile of an international banking group of which the home supervisor is also the lead supervisor. Over time, the supervisory colleges have developed as a forum for broader issues such as discussions and planning of supervisory assessments and sharing information about the overall risk assessment of banking entities as well as the banking group.

**5.40** The IRDA is in the process of setting up a supervisory college for effective supervision of the Life Insurance Corporation (LIC) of India, a financial conglomerate with wide presence in various financial sectors domestically as well as internationally<sup>1</sup>. On the other hand, IRDA is also participating in the supervisory colleges set up in respect of foreign entities having presence in India in the insurance sector.

**5.41** Under the proposed EU resolution framework, cooperation of resolution authorities within the European Union would be done by establishing resolution colleges around the core of the existing supervisory colleges with enhancement in its membership to include resolution authorities. Such colleges would provide a platform for exchange of information between the national authorities and serve as a forum for discussing and deciding joint or coordinated actions in case of cross-border failing banks or other emergency situations. Resolution colleges would be chaired by the resolution authority responsible for the EU parent credit institution (the group level resolution authority) and would be responsible for crisis planning and preparation of resolution plans.

**5.42** Considering the development of supervisory colleges as a forum for sharing information on the overall risk assessment of individual financial entities as well as the financial group and also the fact that the RBI and IRDA have signed MoUs/MMOUs with various jurisdictions/IAIS for sharing of supervisory information, the Group recommends that the supervisory colleges could be used as an information sharing platform for crisis resolution also. However, this needs to be taken up with the relevant authorities and the parties to the supervisory colleges. (Recommendation 39)

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<sup>1</sup>LIC of India has operations in Fiji, Mauritius, Bahrain, Nepal, Sri Lanka, Saudi Arabia and Kenya.



## Constitution of Crisis Management Groups (CMGs) and Institution-specific Cross-border Cooperation Agreements (COAGs)

**5.43** Given the legal mandate to the resolution authority for achieving a cooperative solution with the foreign resolution authorities for orderly resolution, the FSB feels that a policy framework for cross-border cooperation between resolution authorities needs to be developed for advance planning and to avoid dealing with cross-border issues through the courts. With a view to having an easy approach in the near term for such cooperation and enhancing preparedness for and facilitating the management and resolution of a cross-border financial institution, the FSB has suggested constitution of Crisis Management Groups (CMGs) for all G-SIFIs and institution-specific cross-border cooperation agreements (COAGs) at least for G-SIFIs. CMGs should comprise the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for insurance guarantee schemes of jurisdictions that are home or host to entities of the group that are material to its resolution.

**5.44** Generally, for reasons of operational efficiency, practicality, and effective decision-making, the membership of CMGs is limited to those jurisdictions and authorities that are material and significant for a group-wide resolution of the firm. Such a practice could possibly leave out some jurisdictions, where operations of the firm are locally systemic but not material in the context of the overall operations of the financial group, from representation in the CMG. However, the Key Attributes also require cooperation and information sharing between CMGs and authorities in other jurisdictions where the firm has a systemic presence locally but the particular jurisdiction does not participate in the CMG. Towards this end, the FSB is in the process of identifying criteria to assess jurisdictions where operations of a G-SIFI are locally systemic so as to provide guidance on cooperation and information sharing between CMGs and non-CMG host jurisdictions. The FSB considers that as a prerequisite for information sharing, the authorities need to demonstrate that they meet the standards set out in the Key Attributes 7.6, 7.7 and 12.1, and Annex on Information sharing for resolution purposes, which relates to having in place legal gateways and related confidentiality regimes to facilitate effective sharing of non-public information between domestic and foreign authorities for resolution related purposes.

**5.45** The firm's recovery plan is one such information that could be requested by the non-CMG host authority from the home authority in order to assess the potential systemic impact of the recovery plan on the operations in its jurisdiction. Since the plan would generally not address the operation of the G-SIFI in non-CMG jurisdictions but for the critical functions and

material operations only, this could serve as a barrier in advanced planning by the non-CMG host authorities.

**5.46** On the other hand, the main objective of the institution-specific COAG is to facilitate crisis management planning for the specific institution with proper cooperation between the relevant authorities. The agreements could also help in deciding a framework for possible solutions to the legal and other impediments that may exist in effecting an orderly resolution of a financial institution with presence in multiple jurisdictions. Thus, the institution-specific COAGs establishes a framework for the development of RRP, based on the conduct of pre-crisis resolvability assessments, and for cooperation and coordination in a crisis in accordance with the agreed RRP.

**5.47** The essential elements that the institution-specific COAG should possess include:

- Objectives, nature and scope of the agreement
- Roles and responsibilities of authorities
- Commitments of parties to cooperate
- Information sharing
- Implementation of cross-border resolution measures

**5.48** So far, CMGs have been established for all identified G-SIBs. Most jurisdictions that have established CMGs for domestically incorporated G-SIFIs are in the process of concluding institution-specific COAGs between the CMG members. Though none of the Indian financial institutions qualify as G-SIFIs, India is a member of one CMG pertaining to Standard Chartered Bank. These key attributes are generally applicable to G-SIFIs and would be applicable for India only to the extent of having representation in CMGs.

**5.49** The CMGs and institution-specific COAGs are generally applicable to G-SIFIs. In view of the fact that none of Indian banks are G-SIFIs, and even though 15 out of 29 G-SIBs and 8 out of 13 global systemically important insurers (G-SIIs) have presence in India in the form of branches/joint ventures, those are not significant and material in the context of overall operations of the financial group. **The Group recommends that in the situation of an Indian financial institution becoming a G-SIFI in future, the FRA may be empowered to form CMGs and COAGs. (Recommendation 40)**

## CHAPTER 6

### Way Forward

**6.1** The Working Group has taken into account the essential features of a sound and effective resolution regime as prescribed by international standard setting bodies. It, however, needs to be recognized that the guidance on resolution regime is generally more developed and advanced for banks and progressively less for insurers, securities or investment firms and FMIs. In addition, the cross-border issues are still evolving and being addressed. Therefore, FSDC may consider 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.

**6.2** The Group also recognises that different types of financial institutions have distinct features and thus all essential features of a resolution framework as prescribed by international standard setting bodies may not be relevant for all types of financial institutions. The legal framework that will evolve therefore needs to take into account the specificities and peculiarities of different segments of the financial sectors.

# CHAPTER 7

## Summary of Recommendations

The Working Group examined the existing resolution framework for the entire financial sector in India and identified gaps in the framework vis-à-vis FSB Key Attributes. The Group also reviewed international practices and the ongoing developments in major jurisdictions as well as work in progress by the international standard setting bodies. Taking these into account, the Group unanimously offers the following recommendations on the policy framework for setting up a resolution regime in India and sets a direction towards further steps going forward. The recommendations of Working Group are summarised below.

### 1. Policy framework to deal with failures

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. **[Para 4.13]**

### 2. Comprehensive legal framework

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 FMIs. **[Para 4.28]**

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<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.

### 3. Objectives of resolution framework

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.

**[Para 4.32]**

### 4. Scope of resolution framework

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 FMI's 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. **[Para 4.39]**

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. **[Para 4.42]**

## 5. Structure of the resolution authority

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

- (v) there should be a single Financial Resolution Authority (FRA) mandated under the law for resolving all financial institutions and FMs, in coordination/cooperation with the respective financial sector regulators, as deemed necessary by the FRA,
- (vi) the FRA should be institutionally independent of the regulators/supervisors and the Government,
- (vii) 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
- (viii) 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. **[Para 4.51]**

## 6. Mandate of resolution authority

the mandate of FRA will be to resolve failed financial institutions and FMs (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.

**[Para 4.52]**

## 7. Setting up resolution authority

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.

**[Para 4.54]**

## 8. Triggers of early intervention

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. **[Para 4.64]**

## **9. Trigger for resolution**

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. **[Para 4.66]**

## **10. Review and development of PCA framework**

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. **[Para 4.67]**

## **11. PCA framework for financial conglomerates**

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. **[Para 4.71]**

## **12. Resolution tools**

The Group recommends that with a view to carrying out orderly resolution of failing financial institutions and FMI 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. **[Para 4.82]**

### **13. Framework for non-bank financial institutions**

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. **[Para 4.83]**

### **14. Use of bail-in as resolution tool**

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). **[Para 4.91]**

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. **[Para 4.93]**

### **15. Temporary public ownership**

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. **[Para 4.98]**



## 16. Features of resolution fund

With respect to funding of resolution, 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.

**[Para 4.107]**

## 17. Deposit insurance and other protection funds

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. **[Para 4.110]**

## **18. Need for reforms in deposit insurance framework**

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. **[Para 4.111]**

## **19. Recovery and resolution planning**

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.

**[Para 4.122]**

## **20. RRP for FMIs**

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. **[Para 4.125]**

## **21. Determination of SIFIs by regulators**

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. **[Para 4.130]**

## **22. Improving resolvability**

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. **[Para 4.134]**

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. **[Para 4.135]**

## **23. Financial holding company structure**

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. **[Para 4.138]**

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

#### **24. Information sharing between FRA and regulators**

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. **[Para 4.143]**

#### **25. Development and management of database**

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. **[Para 4.145]**

#### **26. Service level agreements**

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. **[Para 4.147]**

#### **27. Framework for set-off, netting and collateral arrangements**

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. **[Para 4.160]**

## **28. Temporary stay on contractual obligations**

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. **[Para 4.164]**

## **29. Claims of secured creditors**

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 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. **[Para 4.165]**

## **30. Hierarchy of claims in distribution of assets/allocation of losses**

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. **[Para 4.170]**

### **31. Preference to depositors, insurance policy holders and investors**

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. **[Para 4.177]**

### **32. Claims of uninsured depositors vis-à-vis DICGC**

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. **[Para 4.178]**

### **33. Right to judicial review of resolution actions**

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. **[Para 4.182]**

### **34. Statutory mandates to foster cross-border cooperation**

Keeping in view plausible opening up of the Indian financial system in future and Indian financial institutions becoming G-SIFIs with large scale cross-border operations, the Group recommends that the proposed legislation for resolution regime for financial institutions should enable the FRA to achieve cooperative solution with foreign resolution authorities. **[Para 5.24]**

### **35. Access to information and information sharing**

While work in the area of cross-border information sharing is underway, which is being enhanced by the FSB through Resolution Steering Group, the Group recommends that the resolution framework in India should enable the FRA to share non-public information of Indian financial institutions with foreign home/host resolution authorities on reciprocal basis and subject to confidentiality requirements and protection for sensitivity. **[Para 5.38]**

### **36. Supervisory Colleges**

Considering the development of supervisory colleges as a forum for sharing information on the overall risk assessment of individual financial entities as well as the financial group and also the fact that the RBI and IRDA have signed MoUs/MMOUs with various jurisdictions/IAIS for sharing of supervisory information, the Group recommends that the supervisory colleges could be used as an information sharing platform for crisis resolution also. However, this needs to be taken up with the relevant authorities and the parties to the supervisory colleges. **[Para 5.42]**

### **37. Constitution of Crisis Management Groups (CMGs) and Institution-specific Cross-border Cooperation Agreements (COAGs)**

The Group recommends that in the situation of an Indian financial institution becoming a G-SIFI in future, the FRA may be empowered to form CMGs and COAGs. **[Para 5.49]**

### **38. Way Forward**

The Working Group has taken into account the essential features of a sound and effective resolution regime as prescribed by international standard setting bodies. It, however, needs to be recognized that the guidance on resolution regime is generally more developed and advanced for banks and progressively less for insurers, securities or investment firms and FMs. In addition, the cross-border issues are still evolving and being addressed. Therefore, FSDC may consider 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 FMs and cross-border issues. **[Para 6.1]**

The Group also recognises that different types of financial institutions have distinct features and thus all essential features of a resolution framework as prescribed by international standard setting bodies may not be relevant for all types of financial institutions. The legal framework that will evolve therefore needs to take into account the specificities and peculiarities of different segments of the financial sectors. **[Para 6.2]**

## Recent Legislative Reforms in Major FSB Jurisdictions

### Resolution Framework in the United States

1. The resolution framework in the US underwent changes in response to the financial crisis by enactment of the Dodd-Frank Act on July 21, 2010. The resolution framework as envisaged under Dodd Frank framework makes a distinction between systemic and non-systemic institutions. The financial firms that are non-systemic are resolved as per their respective laws, while the provisions of Dodd Frank apply in case of systemically determined firms. The Dodd-Frank Act also provides for a framework for better coordination among authorities, domestically and internationally, in recognition of the complexity and global reach of many systemically important financial institutions. U.S. regulators have promulgated rules implementing certain provisions of the Dodd-Frank Act, and continue to develop rules to implement other provisions.

#### *Scope and Coverage*

2. The applicability of Dodd-Frank Act and other laws in resolution of various financial firms (systemic as well as non-systemic) is given below:

- **Banks and other insured deposit-taking institutions** are resolved pursuant to the FDI Act. In addition, domestic branches and agencies of foreign banking organizations are resolved under federal law (for federally licensed branches and agencies) or applicable State law (for state-licensed branches or agencies), where not pre-empted by federal law.
- **Brokers, dealers and other investment firms** for which a systemic determination is made under Section 203 of the Dodd-Frank Act may be resolved under Title II of that Act. Registered brokers, dealers and other investment firms that are not deemed to be systemic are generally resolved pursuant to Securities Investor Protection Act (SIPA). Investment firms that are not registered brokers or dealers may be resolved under the Bankruptcy Code.
- Dodd-Frank Act applies to **insurance companies** for which a systemic determination is made under Section 203 of that Act; however, insurance companies are to be liquidated or rehabilitated as provided under State law. Insurance companies for which no systemic determination is made under Section 203 of the Dodd-Frank Act



are generally resolved in accordance with the applicable requirements of the State in which the insurer is legally domiciled.

- Privately owned and operated **financial market infrastructures** for which a systemic determination is made under Section 203 of the Dodd-Frank Act may be resolved under Title II of that Act. Privately owned and operated financial market infrastructures for which no systemic determination is made under Section 203 of the Dodd-Frank Act may be resolved under the Bankruptcy Code.
- The orderly liquidation authority under Title II of the Dodd-Frank Act may apply to both **financial holding companies and bank holding companies**, including holding companies of insured depository institutions, brokers or dealers, or insurance companies. Under the FDI Act, the resolution authority does not extend to holding companies of insured depository institutions. Under State law, the resolution authority does not extend to holding companies of regulated insurance entities.
- The orderly liquidation authority under the Dodd-Frank Act may extend to certain **subsidiaries of a covered financial company** subject to the orderly liquidation authority. Under the FDI Act, the resolution authority does not extend to operational affiliates of insured depository institutions but the resolution authority would generally control subsidiaries as an equity holder of such entities. Under State law, the resolution authority does not extend to non-subsidiary operational affiliates of regulated insurance entities.

#### *Scope of Dodd-Frank Act*

3. The orderly liquidation authority established in 2010 under Title II of the Dodd-Frank Act applies to bank holding companies and certain other financial companies (including privately owned and operated financial market infrastructures) and certain of their subsidiaries whose “failure ... and resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States.” “Financial companies” include bank holding companies, nonbank financial companies supervised by the Federal Reserve Board, any company that is predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto, and any subsidiary thereof that is predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto (other than a subsidiary that is an insured depository institution or an insurance company).

4. More specifically, the orderly liquidation authority under Title II of the Dodd-Frank Act applies to a financial company only following, among other things, an evaluation by the specified U.S. agencies as to why a case under the Bankruptcy Code is inappropriate and a

determination by the Secretary, in consultation with the President of the United States, that such financial company's failure and resolution under otherwise applicable Federal or State law would have serious adverse effects on U.S. financial stability. Such a determination is made as part of the decision to put the financial company into resolution under the orderly liquidation authority of the Dodd-Frank Act.

#### *Role of FDIC*

5. The powers granted to the FDIC as receiver under Title II of the Dodd-Frank Act are analogous to those the FDIC uses to resolve failed insured depository institutions under the FDI Act. The FDIC must exercise these powers in a manner which is intended to preserve financial stability while minimizing moral hazard. These authorities include

- (i) an immediate source of liquidity for an orderly liquidation, which allows continuation of essential functions and maintains asset values;
- (ii) the ability to make advance dividends on creditor claims and prompt distributions to creditors based upon expected recoveries;
- (iii) the ability to continue key, systemically important operations, including through the formation of one or more bridge financial companies; and
- (iv) the ability to transfer all qualified financial contracts with a given counterparty to another entity (such as a bridge financial company) and avoid their immediate termination and liquidation to preserve value and promote stability.

6. Under the reforms, the FDIC's resolution authority is significantly expanded. The FDIC is to be appointed receiver for failed systemically important financial companies under the Dodd-Frank Act and for failed insured depository institutions under the FDI Act. The FDIC must be appointed as receiver for insured federal savings associations and national banks. For state chartered and Federal Reserve member banks, the chartering authority has the option of appointing the FDIC as receiver, although rarely has another entity been appointed.

7. In addition, the FDIC as receiver of a covered financial company under Title II of the Dodd-Frank Act may, in certain circumstances, appoint itself receiver for any of the covered financial company's subsidiaries that are not themselves insured depository institutions, insurance companies, or certain brokers or dealers. In the event of multiple resolution proceedings for separate legal entity subsidiaries of a parent holding company deemed to be systemically significant, the FDIC would retain the role as lead resolution authority for the entire financial group.

8. Arrangements for cooperation and communication are typically set out in statutes. For example, the Dodd-Frank Act requires that when the FDIC acts as receiver for a covered broker or dealer, the FDIC must appoint the Securities Investor Protection Corporation (SIPC) to act as trustee. Where the FDIC is appointed receiver for an insurance company, such resolution is required to be conducted in accordance with applicable State law. The Dodd-Frank Act also contemplates consultation by the FDIC as receiver with SIPC and the Securities and Exchange Commission (SEC) in connection with the determination of whether to transfer customer accounts of a covered broker or dealer to another broker or dealer rather than to a bridge financial company.

### *Triggers for Resolution*

9. Under the FDI Act, the decision to resolve an insured depository institution is made by its Federal or State chartering authority. If the chartering authority decides to place the institution into receivership, the FDIC must be appointed receiver. Under the FDI Act, intervention will be triggered by the failure of an insured depository institution to maintain adequate capital, and/or operating in an unsafe or unsound condition. Triggering events include:

- (i) failure to maintain adequate capital (below a tangible capital to assets level of less than 2 per cent of assets under the prompt corrective action scheme);
- (ii) assets are less than the institution's obligations;
- (iii) substantial dissipation of assets due to any violation of any statute or regulation, or any unsafe or unsound practice;
- (iv) an unsafe or unsound condition to transact business;
- (v) any wilful violation of a cease-and-desist order;
- (vi) any concealment of the institution's books, papers, records, or assets;
- (vii) the institution is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business;
- (viii) the institution has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the institution to become adequately capitalized without federal assistance;
- (ix) any violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the institution's condition or otherwise seriously prejudice the interests of the institution's depositors or the deposit insurance fund;
- (x) the institution consents to the appointment;
- (xi) the institution ceases to be an insured institution;

- (xii) the institution is undercapitalized under the prompt corrective action scheme and
  - (a) has no reasonable prospect of becoming adequately capitalized; (b) fails to become adequately capitalized when required to do so; (c) fails to submit a capital restoration plan acceptable to its federal supervisor within the time prescribed; or
  - (d) materially fails to implement a capital restoration plan;
- (xiii) the insured depository institution is critically undercapitalized;
- (xiv) for national banks, the bank has fewer than five directors;
- (xv) the insured depository institution has been found guilty of a money laundering offense;
- (xvi) under the Dodd-Frank Act, the insured depository institution defaults on an obligation guaranteed by the FDIC; and
- (xvii) for a federally licensed branch of a parent foreign bank, if the Comptroller of the Currency is of the opinion or has reason to believe that such foreign bank has violated or failed to comply with any of the relevant provisions, or any rules, regulations or orders of the Comptroller of the Currency, or a conservator is appointed for such foreign bank or a similar proceeding is initiated in the foreign bank's country of organization.

10. Under the Dodd-Frank Act, a financial company is subject to orderly liquidation following the statutorily prescribed recommendation, determination and expedited judicial review process, which includes the requirement that the Secretary determine, among other things, that the financial company is in default or in danger of default. Section 203(c)(4) of the Dodd-Frank Act provides that, for purposes of Title II of the Dodd-Frank Act, a financial company shall be considered to be in default or in danger of default if -

- a) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code,
- b) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion,
- c) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others, or
- d) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

11. In order for the FDIC to be appointed receiver under Title II of the Dodd-Frank Act for a failed or failing systemically important financial company, a recommendation, determination and expedited judicial review process must transpire. The recommendation process is initiated at the Secretary's request or upon the initiative of the Federal Reserve Board and the FDIC, in the case of a standard financial company. The recommendation to place a broker or dealer (or a financial company in which the largest domestic subsidiary is a broker or dealer) into receivership is made by the Federal Reserve Board and the SEC, in consultation with the FDIC. Similarly, the recommendation to place an insurance company (or a financial company in which the largest domestic subsidiary is an insurance company) is made by the Federal Reserve Board and the Director of the Federal Insurance Office, in consultation with the FDIC. In each instance, the decision to resolve a financial company is simultaneously a decision under the statute to appoint the FDIC as receiver for the failed financial company.

12. Upon a 2/3 vote by both boards (or a 2/3 vote by the Federal Reserve Board and the SEC in the case of a broker or dealer or a financial company in which the largest domestic subsidiary is a broker or dealer, or a 2/3 vote by the Federal Reserve Board and the approval of the Director of the Federal Insurance Office in the case of an insurance company or a financial company in which the largest domestic subsidiary is an insurance company), a written recommendation is delivered to the Secretary. The written recommendation must include: an evaluation of whether the financial company is in default or danger of default; a description of the effect the failure of the financial company would have upon U.S. financial stability; an evaluation of why a case under the Bankruptcy Code is not appropriate; and certain other evaluations required by statute.

13. The Secretary, in consultation with the President, is responsible for making a determination as to whether the financial company should be placed into receivership under the Dodd-Frank Act. Such determination must include, among other things, the Secretary's determination that the financial company is in default or in danger of default, that the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on U.S. financial stability, and that an orderly resolution under Title II would avoid or mitigate the adverse risks to U.S. financial stability.

14. The FDIC is appointed receiver of the financial company following successful completion of an expedited judicial review process. Under that statutory process, the board of directors of the financial company may acquiesce to the appointment of the FDIC as receiver. If the board of directors does not acquiesce to the appointment, the Secretary is

responsible for petitioning the District Court for the District of Columbia for a hearing. The hearing is confidential. Its results may be appealed, but there is no stay pending any such appeal.

15. If the District Court does not make a determination within 24 hours of receipt of the Secretary's petition, the Secretary's petition is granted by operation of law, and the FDIC is appointed receiver of the covered financial company.

## ***Resolution Tools***

### *Purchase and Assumption Transactions*

16. The most common resolution method used by FDIC for failing banks and thrifts is the purchase and assumption (P&A) transaction. A P&A transaction is a closed institution transaction in which a healthy institution (generally referred to as either the acquirer or the "assuming" bank or thrift) purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. Occasionally, an acquirer may receive assistance from the FDIC as insurer to complete the transaction. As a part of the P&A transaction, the acquirer usually pays a premium to the FDIC for the assumed deposits, which decreases the total resolution cost.

### *Deposit Payoffs*

17. A deposit payoff is only executed if the FDIC does not receive a bid for a P&A transaction that meets the least cost test. There are two types of deposit payoffs. The first type is a straight deposit payoff, in which the FDIC in its corporate capacity ensures that each depositor is paid the amount due, up to the insured limit. The second type is an insured deposit transfer, in which insured deposits and secured liabilities of a failed bank or thrift are transferred to a healthy institution, and service to insured depositors is uninterrupted.

### *Bridge tool*

18. Under the Dodd-Frank Act and the FDI Act, a receiver is generally appointed in respect of a failed financial company or insured depository institution, respectively, at which time such institution is closed. The receiver has the authority to manage and operate assets and operations of the predecessor institution in resolution, including by use of a bridge entity. In addition, the FDIC is authorized under both the Dodd-Frank Act and the FDI Act to utilize private persons to, among other things, provide management services in respect of bridge institutions and entities in resolution. The FDIC can repudiate contracts, transfer contracts, purchase and sell assets, and has other powers necessary to resolve the failed institution, including by establishing a bridge institution. In addition, the FDIC can manage, through a

receivership or one or more bridge entities, the assets and operations of the failed firm in receivership. The FDIC is empowered to operate the failed insured depository institution or covered financial company with all of the powers of the members or shareholders, the directors, and the officers of the entity, and to conduct all business of the entity.

19. Under both the Dodd-Frank Act and the FDI Act, a bridge institution may operate without any capital or surplus, or with such capital or surplus as the FDIC as receiver may in its discretion determine to be appropriate. The FDIC as receiver also has discretion to cause capital stock or other securities of a bridge institution to be issued and offered for sale in amounts and on terms and conditions as the Corporation may determine. Under the Dodd-Frank Act, the status of a bridge financial company shall terminate as such upon, among other things, the sale of 80 per cent or more of its capital stock to a person or entity other than the FDIC or another bridge financial company. Under both the Dodd-Frank Act and the FDI Act, the FDIC as receiver may in its discretion either raise capital or make funds available for the operation of the bridge institution in lieu of capital. Under the Dodd-Frank Act, the FDIC as receiver may authorize a bridge institution to obtain credit.

20. The transfer of assets or liabilities from the institution in an FDIC receivership to the bridge institution is typically effectuated through purchase and assumption agreements. Typically, the terms of the purchase and assumption agreements provide for only a limited period during which assets or liabilities transferred to a bridge institution may be put back to the receivership, and then only for purposes consistent with efficient resolution.

#### *Single Point Entry*

21. The FDIC has developed a resolution strategy - the single point of entry creditor capitalization resolution strategy - that is being specifically tailored for use in the resolution of those global systemically important financial institutions (“G-SIFIs”) that are potentially subject to the FDIC’s resolution authority under Title II. Under this still-evolving resolution strategy, the FDIC will be appointed as receiver of the ultimate parent holding company of the financial group following the company’s failure and the completion of the appointment process set forth in Title II of the Dodd-Frank Act. Immediately following the parent holding company being placed into receivership, a bridge financial company will be formed into which the assets of the failed financial company, including its investments in and loans to subsidiaries, will be transferred. This newly-formed bridge financial company will allow the enterprise to continue to perform the systemically important functions of the failed financial company, thereby minimizing disruptions to the financial system and minimizing the risk of spill over effects to counterparties. Subsidiaries - both domestic and foreign - of the financial

company may remain open and operating. The Orderly Liquidation Fund will be available to provide liquidity and guarantees, as necessary, to the bridge financial company, which will then serve as a source of strength to its subsidiaries by arranging for necessary funding. Following completion of a valuation and claims process, the enterprise may be recapitalized by creditors in the failed financial company receiving a combination of equity and new debt in the new financial company in satisfaction of their claims against the receivership.

22. The FDIC has broad discretion in exercising the single point of entry creditor capitalization resolution strategy (e.g., bail-in within resolution). The receiver has the authority to exercise this resolution strategy by satisfying creditor claims through provision of equity in a newly formed bridge entity. The FDIC anticipates that in most cases, general creditor claims such as long-term unsecured debt would be subject to conversion to equity. Such debt would not be limited to pre-defined instruments such as contingent capital. As part of the claims administration process, the receiver is required to administer claims in accordance with the statutory order of priorities.

#### ***Funding for Operational Expenses***

23. The operations of the FDIC acting in its corporate capacity are generally funded by the Deposit Insurance Fund, which is funded through regular assessments on insured depository institutions. With respect to operations of the FDIC in its capacity as receiver of failed insured depository institutions, such operations are funded by the assets of the failed insured depository institution and, if necessary, the Deposit Insurance Fund.

24. Reasonable implementation expenses of the FDIC incurred as part of its efforts to implement Title II of the Dodd-Frank Act, including expenses related to the development of policies, procedures, rules and regulations and other planning activities, are to be reimbursed by the Financial Stability Oversight Council (FSOC). The FSOC's expenses are funded through assessments on industry participants by the Office of Financial Research. The FDIC's operations relating to the resolution of covered financial companies under Title II of the Dodd-Frank Act are funded by the assets of the failed covered financial company and the Orderly Liquidation Fund. If the proceeds of the resolution of the failed covered financial company are insufficient to repay any amounts borrowed from the Orderly Liquidation Fund, such shortfall is funded through risk-based assessments on certain financial companies. By law, taxpayers shall bear no losses from the FDIC's exercise of authority under Title II of the Dodd-Frank Act.

25. The Dodd-Frank Act amended the FDI Act to prohibit the FDIC from providing



assistance to an open insured depository institution. Similarly, Section 1101 of the Dodd-Frank Act amended the FRA to prohibit the Federal Reserve Board from providing certain emergency assistance to insolvent institutions.

26. With respect to securities investors, SIPA created a SIPA Fund, which may be used by SIPC in the resolution of a broker or dealer. SIPC uses the fund to advance to the trustee for the liquidation up to \$500,000 for each customer of the broker or dealer with a claim for cash or securities as may be required to pay or otherwise satisfy customer claims when such customer claims exceed the pro rata share of customer property. With respect to insurance entities, State-operated guaranty funds compensate claimants according to the limits of State laws. Insurance guaranty funds are funded by assessments on the remaining industry participants offering coverage for that line of insurance in that State.

#### ***Order of priorities in claims***

27. As part of the claims administration process, the receiver is required to administer claims in accordance with the statutory order of priorities. Under the priority scheme, subordinated claims, general creditor claims (which would include senior unsecured claims) are subordinate to certain other claims, including administrative claims, and therefore may be subject to loss. Equity interests are the lowest priority claim. Accordingly, an equity claimant would not be entitled to receive any remuneration (including any interest in a newly formed bridge entity) until all other creditors, including general unsecured creditors and subordinated creditors, had been paid in full.

#### ***Recovery and resolution planning***

28. Under Title II of the Dodd-Frank Act, the FDIC is the resolution authority for failing financial companies for which a systemic determination is made under Section 203 of that Act. Accordingly, the FDIC is preparing standby resolution plans and resolution strategies to be able to exercise this authority, if necessary, in the event of the failure of such an institution. The U.S. banking agencies, under their supervisory powers and safety-and-soundness authority, requested the largest globally active U.S. banking organizations to develop recovery plans beginning in 2010. The Federal Reserve expects to provide additional guidance related to recovery planning and require all U.S. G-SIFIs to create and maintain recovery plans by the end of 2013.

#### ***Information sharing arrangements***

29. The U.S. banking agencies have authority to share information with domestic and foreign regulatory and supervisory agencies, as well as with “any person that the Federal

banking agency determines to be appropriate.” An authority would generally be considered an “appropriate” or “proper” recipient if it has supervisory or resolution responsibilities for a financial institution, it has a clear and legitimate need for the information in order to carry out those responsibilities, and it agrees to keep the information confidential to the fullest extent possible under applicable law. As a general matter, only information directly relevant to the specific statutory responsibilities of an authority would be shared with that authority.

30. The U.S. banking agencies may share all types of information (including customer and firm-specific data) related to the recipient’s responsibilities for supervision and resolution of financial institutions. Customer data is afforded a high degree of protection and is generally not shared unless a foreign authority has a specific supervisory or resolution-related need for such information. There are, however, no significant legal hurdles to sharing such information in appropriate circumstances.

31. The U.S. banking agencies require the recipient of shared information to agree to maintain the confidentiality of the information under a fully adequate legal regime and to the fullest extent permitted by law. Before providing information to foreign authorities, the U.S. banking agencies generally request and evaluate information about the legal regime governing protection of information in the foreign authority’s jurisdiction. The U.S. banking agencies would not provide information (or would provide more limited information) if the foreign legal regime did not appear adequate to protect it.

32. Generally, the agency disclosing the information must determine that such disclosure will not prejudice the interests of the United States. Further, pursuant to the regulations cited above, the authority making the request must also demonstrate a need for the information.

33. Whether an MOU is necessary or appropriate depends on the circumstances. For sharing information between certain agencies, including the U.S. banking agencies, MoUs are not required, but a recipient authority would generally be required to agree in writing to use information only for the purposes of supervision, recovery and resolution planning, and resolution, and to keep it confidential to the fullest extent permitted by law. In most cases, reciprocity is not a requirement, but the U.S. banking agencies and the SEC would take into account an authority’s willingness to share relevant information on a reciprocal basis.

34. Information provided to an agency by a third party would not generally be shared unless the person that provided it consents or such information is of a nature that it is not protected for some reason, for example, it is the subject of certain law enforcement

investigations. The U.S. banking agencies will only be able to share information obtained from or produced jointly with other domestic authorities (e.g., state banking supervisors) with foreign authorities with a role in resolution if the domestic authority that provided or jointly produced the information agrees to such disclosure.

## Resolution Framework in the United Kingdom

35. The institutional framework for regulation of financial sector and bank resolution is governed by the following agencies:

- *Her Majesty's Treasury (HMT)*: in addition to the overall institutional structure of financial regulation and the legislation that governs it, informs to parliament regarding the management of serious disruptions to the financial system and measures to resolve them (including exceptional solvency support from HMT itself).
- *Bank of England (BoE)*: acts as lender of last resort in order to limit risk of problems affecting a particular institution from spreading to other parts of the system. It acts as the lead resolution authority for failing U.K. banks and building societies under the special resolution regime introduced by the Banking Act, 2009 (BA).
- *Financial Services Authority (FSA)*: Acts as prudential supervisor with key operational role of resolving problems at firms prior to resolution via capital raising; and business disposals. Triggers the Special Resolution Regime (SRR) and is responsible for authorization and supervision of bridge banks created under the SRR.
- *Financial Services Compensation Scheme (FSCS)*: FSCS, an operationally independent body accountable to the FSA, manages a protection scheme with five sub-schemes for different categories of customers, one of those being insured depositors in deposit-taking institutions.

### **Banking Act 2009**

36. Pre-crisis, the resolution of U.K. banks had relied on general corporate insolvency law (codified largely in The Insolvency Act of 1986). Lacking an appropriate legal framework for bank resolution, the United Kingdom responded to the failure of Northern Rock by adopting the Banking (Special Provisions) Act, 2008 (BSPA) in February 2008 as an emergency, temporary measure with a sunset clause of one year. The BSPA provided broad powers (based around forced changes to capital structure and mandatory transfers of property) to HMT used in the resolution of Northern Rock and other problem banks.

37. The BA establishes a permanent resolution framework built around a SRR for resolving banks, which includes a set of directed transfer powers (referred to as “stabilization

powers” in BA) and a Bank Insolvency Procedure (BIP) for winding up insolvent banks in a manner protecting insured depositors. The BA, inter alia, sets out the trigger points for invoking the SRR, the objectives of the SRR, the various stabilization (i.e., transfer) options under the SRR, and the tools for achieving the desired results. The BA confers on the BoE and HMT powers to effect specific stabilization options in various situations and creates an obligation to consult with other authorities. Important secondary legislation sets out the standards for compensation to stakeholders affected by the resolution and also provides important creditor safeguards, preventing property transfer powers from being used in ways that could interfere with netting, security interests, and collateral rights for the mitigation of credit risk, and ensuring that in partial property transfers creditors are left no worse off than if the whole bank had been liquidated.

### ***Special Resolution Regime***

#### *Objectives*

38. The SRR provides a major step forward in U.K. legislation and has been in many respects the model for the current proposed resolution framework in the EU. When taking or contemplating any action under the SRR, the authorities must have regard to specified objectives. The objectives are not ranked according to any priority and their relative importance depends on the particular situation.

- Objective 1: to protect and enhance the stability of the financial systems of the United Kingdom
- Objective 2: to protect and enhance public confidence in the stability of the banking systems of the United Kingdom.
- Objective 3: to protect depositors
- Objective 4: to protect public funds
- Objective 5: to avoid interfering with property rights in contravention of a convention right (within the meaning of the Human Rights Act 1998).

#### *Resolution Tools*

39. The SRR comprises three ‘stabilization options’ for resolving a troubled bank (i) transfer to a private sector purchaser; (ii) transfer to a bridge bank; and (iii) temporary public ownership. In this context, a ‘bank’ is effectively defined as an authorized deposit taking firm (per S2(1) of the Act). The stabilization options are effected by way of the “stabilization powers” which are the share and property transfer powers. The property transfer powers can be used to transfer only part of the property of the bank. The legislation also includes: (i) a bank insolvency procedure (BIP) for winding up a bank (in a manner that fully protects insured depositors) that is not resolved using a stabilization option; and (ii) a bank

administration procedure (BAP) to govern the insolvency of a residual entity that is left behind after the use of the property transfer powers where they have been exercised to transfer only part of the business of the BoE.

40. Before any stabilization power is used, the FSA (now Prudential Regulation Authority (PRA)<sup>1</sup>) must determine that both of the following 'general conditions' have been satisfied: condition 1 is that the bank is failing, or is likely to fail, to satisfy the threshold conditions for holding a banking license; and condition 2 is that having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilization powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions. The threshold conditions that are relevant to the FSA's determination are all of the conditions that an entity must fulfill in order to be authorized to carry out the regulated activity of deposit taking. While this covers a range of both qualitative and quantitative criteria, the most important conditions for SRR purposes would be prudential standards. Although the FSA makes the determination of the general conditions, the legislation requires it to consult with HMT and BoE.

41. If the general conditions are met, either the BoE (for transfer to a private sector purchaser or bridge bank) or HMT (for Temporary Public Ownership (TPO)) may use a stabilization option, subject to the relevant 'specific conditions'. Essentially, the specific conditions are public interest tests, where the relevant authority (whether the BoE or HMT) have to be satisfied that use of a stabilization option is necessary to counter a threat to U.K. financial stability or to protect the public interest. The threshold in the legislation is highest for TPO. The TPO is a 'last resort' option depending on necessity to counter a "serious threat" to financial stability. (In certain situations, the TPO power may also permit HMT to place a holding company in temporary public ownership). While the BoE and HMT have primary responsibility for determining if specific conditions are met, the legislation requires that they consult with each other and the FSA. If no specific conditions for using a stabilization option are met, the bank would be placed into the bank insolvency procedure with insured deposits being transferred to another bank, or FSCS paying out to insured depositors as rapidly as possible. It should be noted that even if the specific conditions are

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<sup>1</sup>The Prudential Regulation Authority (PRA), as part of the Bank of England, has become the United Kingdom's prudential regulator for banks, building societies and credit unions (collectively called deposit-takers), insurers and major investment firms. Accordingly, the Financial Services Authority (FSA) now ceases to exist. The PRA, whose objective is to promote the safety and soundness of these firms, seeking to minimize the adverse effects that they can have on the stability of the UK financial system, and contribute to ensuring that the insurance policyholders are appropriately protected. The PRA works with the Bank of England's Special Resolution Unit, which plans for and implements resolutions of failing UK banks and building societies, on resolution and operational resilience.

met for any of the stabilization options, the relevant authority need not take that action (i.e., the authority is not under a duty to do so, rather they have available the power to take the relevant action where the conditions are met).

42. Upon entry into the SRR, the BoE is the lead authority (except for TPO—for which HMT leads) conducting any sale of the bank to private parties or, as an intermediate measure, by establishing a bridge bank. After transfer powers have been used, the SRR also includes a bank administration process for the insolvency of the residual entity. An important feature of the bank administration process is a requirement for the residual institution in administration to provide continued services and facilities as needed to the recipient of the transferred business to enable it to operate effectively.

#### *Scope of SRR*

43. The SRR is applicable to commercial banks and, with some modifications to building societies that are authorized to accept deposits in the United Kingdom. BA provisions may also apply to credit unions, after a regulation by HMT to implement this provision in the legislation. The U.K. holding companies of banking groups are included to a limited extent (TPO is the only stabilization option to which holding companies may be subject). Also certain “continuity obligations” may be imposed on a residual bank or other banking group companies to continue to provide services and facilities to a solvent transferee (including a bridge bank) to which part or all of the business of a failing bank has been transferred. But the stabilization powers of the SRR are largely orientated at deposit-taking entities.

#### *Triggers for the SRR*

44. The triggers for initiation of the key powers available in the UK SRR are set out in Section 7 of the Banking Act. They are twofold and both conditions must be satisfied. First, the bank must be failing, or likely to fail, to satisfy its ‘threshold conditions’. Second, it must not be reasonably likely that action will be taken by or in respect of the bank (other than potentially through the SRR) that would enable it once again to satisfy the threshold conditions.

45. The main reason for using the threshold conditions as the trigger is that these are the regulatory requirements which any UK bank undertakes to meet in order to gain authorisation from the FSA to accept deposits and carry out regulated banking activities. It is appropriate, therefore, that banks that no longer meet the conditions for authorisation, and have no prospect of doing so in future, should be placed into the SRR and may lose their deposit-taking authority.

46. These decisions are in essence regulatory judgements and so are taken by the FSA in the United Kingdom. The United Kingdom is no different from virtually all other major countries with special regimes in assigning to the banking supervisors the right to trigger the SRR. This does of course raise the generic and frequently highlighted risk of regulatory forbearance, which in this case means that the banking supervisors may delay too long in triggering the regime. This risk is partly addressed in the United Kingdom by a key aspect of the design of the triggers, which is that they enable a failing bank to be placed into resolution before it is balance sheet insolvent. In addition, in UK, the Bank of England has been given the right to make a recommendation to the FSA to trigger the regime.

#### *Partial property transfers*

47. The most widely commented-upon aspect of the UK SRR is the power of the authorities to split up a bank and effect a partial property transfer (PPT). The PPT powers are closely modelled on the US approach in particular. When the FDIC exercises its power to transfer part of the assets and liabilities (including financial contracts and derivatives) of a failed bank (either to a PSP or a bridge bank), it simultaneously establishes a 'receivership', into which the remaining assets and liabilities are placed. The receivership is very similar to the bank administration procedure (BAP) that comes into effect in a PPT under the UK SRR. In both cases, essential facilities or services that has not been possible to transfer may be used to support the PSP or bridge bank as necessary, while assets can be moved between the two entities in order to maximise the chances of effecting a going concern sale at a premium of as many as possible of the failed bank's assets.

48. The current crisis has resulted in increasing interest in the use of PPTs, bridge banks and good bank/bad bank resolution approaches, given the cost and difficulty of arranging whole-bank resolutions when there are no current buyers for substantial parts of failed banks' assets. In these circumstances, one of the key advantages of a PPT is that it makes it possible to effect a resolution at lower cost to the taxpayer, for example by allowing a greater proportion of the losses to be imposed on junior creditors, such as subordinated debt holders, whose claims may be left behind in the rump of the failed bank rather than being transferred to a private sector purchaser or bridge bank.

#### *Creditor and counterparty safeguards*

49. The UK SRR contains a number of explicit safeguards designed to protect creditors, counterparties and shareholders of a failed bank, especially in a PPT. The US SRR also features a version of the no creditor worse off safeguard, which was adopted in 1989. There is no depositor preference in the UK SRR, so the FSCS, when subrogated to the claims of

eligible depositors, will rank equally with the non-depositor unsecured creditors in the BIP or BAP. Further, where the SRR powers are exercised in a way that would interfere with a shareholder's, counterparty's or creditor's rights by depriving them of their contractual or property rights, the shareholder, counterparty or creditor has a valid claim to proportionate compensation under the Human Rights Act (enshrining the ECHR in UK law). The Banking Act provides a detailed framework for the payment of compensation to such claimants.

#### *Financing Bank Resolution*

50. The FSCS (the U.K.'s DGS) may participate in funding resolution under the SRR. The role of the scheme is not limited to repayment in liquidation. Indeed, it 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 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.

#### *Financial Services Compensation Scheme*

51. The FSCS is an ex-post funded scheme so when the scheme has incurred costs, the membership, which consists of all institutions having insured deposits, will be required to cover the costs on a pro rata basis (respective share of protected deposits up to the compensation limit per individual depositor per authorized bank). The principal costs for the pay-outs during 2008 have not yet been allocated, awaiting the liquidation proceedings, which will decide the final net costs to the FSCS. In the meantime, the Treasury has provided the FSCS with a loan, the principal of which will be repaid from 2012 onwards (interest on the loans is currently being repaid). In winding up procedures, when the FSCS is subrogated to transferred depositors, the FSCS ranks pari-passu with other unsecured creditors.

52. FSCS funds may be used for:

- (i) Pay-out to depositors in an application of the bank insolvency procedure.
- (ii) Financing the transfer of insured deposits to another institution under the bank insolvency procedure.
- (iii) Contributing to a non-payout resolution of a failed bank using the stabilization powers. In this case, the FSCS will only act upon the order of HMT and the FSCS; contribution must be no more costly to the FSCS, net of recoveries, than if the payout/liquidation option had been used.



## Draft EU Framework for Bank Recovery and Resolution

53. The EU bank insolvency regime is governed by Directive 2001/24/EC, which provides exclusive competence for the home member state to take reorganisation measures and to initiate liquidation proceedings in order to resolve a parent bank and its branches in a single insolvency proceeding. As per the Directive, a credit institution is to be resolved in accordance with the laws and regulations applicable in its home member state (which is the competent country) insofar as the Directive does not provide otherwise. The Directive determines the competency and applicable law in the case of cross-border bank insolvency, but it does not harmonise the substantive laws of member states. Further, the Directive only covers insolvency of a parent bank with branches. It excludes from its scope the banking and financial groups consisting of subsidiaries. The host country authorities are competent to deal with the insolvency of subsidiaries.

### *Proposed EU Directive*

#### *Scope and Objectives*

54. A proposed Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms establishes a regime relating to the recovery, resolution and orderly dissolution of failing credit institutions and certain investment firms and their subsidiary financial institutions and firms that are covered by the supervision of the parent undertaking on a consolidated basis. The regime also applies to financial holding companies, mixed financial holding companies, mixed activity holding companies and branches of institutions having their head office outside the EU under the specific conditions laid down in the Directive. The resolution objectives are to ensure the continuity of critical functions; to avoid significant adverse effects on financial stability and to protect public funds, insured depositors, client funds and client assets.

#### *Institutional Framework*

55. The proposed Directive requires EU member states to appoint one or more public administrative authorities as resolution authorities that should have sufficient expertise and resources to manage bank resolutions at national and cross-border levels. The resolution authorities can be central banks, financial supervisors, deposit insurance agency or special authorities. However, if a resolution authority is established within a supervisory institution, then the functional separation of two activities is suggested in order to minimise the risk of supervisory forbearance. In terms of institutional design for cross-border resolution, the proposed Directive envisages that group-level resolution authorities shall establish resolution

colleges with a clear leadership and with the participation of the European Banking Authority (EBA). All the national authorities involved in the resolution of institutions should be represented in resolution colleges.

#### *Early intervention and trigger point*

56. The proposed Directive enhances the powers of supervisors to intervene at the early stage of financial difficulties where an institution does not meet or is likely to breach the regulatory capital requirements. These powers essentially supplement the powers provided to supervisors under EU banking legislation. The powers comprise the capacity to require the institution to implement measures set out in the recovery plan; to prepare an action programme and a timetable for its implementation; to require the management to convene, or to convene directly, the shareholders' meeting, to propose the agenda and the adoption of certain decisions; to require the management to remove and replace one or more board members or managing directors; to require the institution to prepare a plan for restructuring of debt with its creditors; to acquire all necessary information in order to prepare the resolution and to contact potential purchasers. Moreover, the supervisors will have the power to appoint a special manager to replace the management of the institution for a limited period with a duty to restore the financial situation of the institution and to ensure the sound and prudent management of its business.

57. The proposed Directive aims to harmonise the triggers for the application of resolution tools. It is recognised that regulatory forbearance until the point of insolvency will limit the choice of effective options for resolution or increase the costs of resolution and the losses incurred by creditors. Therefore, to protect financial stability, the trigger conditions for the employment of resolution tools and powers ensure that authorities can take actions without being required to establish that the institution in question is insolvent. Thus, it would be possible to place the institution into resolution before it is balance-sheet insolvent and all equity has been exhausted. However, failing to meet authorisation requirements should not justify per se initiating resolution proceedings, in particular if the institution is still or likely to be viable. In this respect, an institution is regarded as failing, or likely to fail, if the institution has incurred, or is likely to incur, losses that will deplete all or most of its capital, or its assets are, or are likely to be, less than its liabilities, or it is, or is likely to be, unable to pay its debts as they fall due or it requires extraordinary public financial support.

#### *Resolution Tools*

58. The proposed Directive provides resolution authorities with the power to apply certain resolution tools including the sale of business tool, the bridge institution tool, the asset

separation tool and the bail-in tool, when the trigger conditions for resolution are determined. The Directive presents a minimum set of resolution tools that should be adopted; however, member states will be able to additionally retain specific national tools and powers to deal with failing banks when they are compatible with the principles and objectives of the EU bank resolution framework.

59. The sale of business tool comprises both merger/acquisition and purchase and assumption transactions. Thus, resolution authorities will be able to affect a sale of the institution, or the whole or part of its business on commercial terms, without the consent of shareholders or complying with procedural requirements that would otherwise apply. In this regard, disclosure of information concerning the marketing of a failed institution and the negotiations with potential acquirers might be delayed to protect financial stability.

60. Under the bridge institution tool, resolution authorities will have the power to transfer all or part of the business of an institution to a publicly controlled bridge institution that operates temporarily to ensure that essential financial services continue to be provided to the customers and that essential financial activities continue to be performed. This institution should be put back on the market, or wound down when market conditions are appropriate.

61. The asset separation tool refers to good-bank/bad-bank separation, in which the resolution authorities will be able to transfer impaired or problem assets to an asset management vehicle or a bad bank to allow them to be managed and worked out over time. The asset separation tool should only be employed in conjunction with another resolution tool in order to minimise competitive distortions and risks of moral hazard.

62. The proposed Directive also includes the bail-in tool, which can be employed to recapitalise a failing institution, allowing authorities to restructure it through an open-bank resolution as a going concern. It may also be employed in cases where the failing bank is closed, for instance, to convert claims of creditors against the failed bank into equity in a bridge bank. This tool would provide resolution authorities a great flexibility in their response to the failure of large, complex financial institution, and would be accompanied by removal of management responsible for the problems of the institution and the implementation of a business reorganisation plan in cases where it is applied to restore the capital of the failing institution to enable it to continue its operation as a going concern. The bail-in tool should not be applied to secured claims as well as certain type of unsecured claims such as insured deposits, liabilities to employees of the failing institution or commercial claims that relate to goods and services necessary for the daily functioning of the institution. The application of

bail-in tool should respect the equal treatment of creditors and the statutory ranking of claims.

#### *Resolution powers and stakeholders safeguards*

63. The proposed Directive confers resolution authorities all necessary legal powers that may be exercised in the application of the resolution tools, including the powers to transfer shares in, or assets, rights and liabilities of, a failing institution to another entity such as another credit institution or a bridge institution; powers to write off or cancel shares or write down or convert debt of a failing institution and power to replace the management. However, the proposed Directive does not prescribe the exact means through which the resolution authorities should intervene in the insolvent institutions.

64. The effective implementation of resolution tools and transfer of assets and liabilities requires allowing resolution authorities to impose a temporary stay, which would last no longer until 17:00 on the next business day, on the exercise by creditors and counterparties of rights to enforce claims and close-out, accelerate or otherwise terminate contracts against a failing institution. Such a temporary stay provides authorities a period of time to identify and value those contracts that need to be transferred to a solvent third party, without the risk that financial contracts would change in value and scope as counterparties exercised termination rights. Termination rights for those counterparties remaining with the failed institution would resume at the end of the stay. Nonetheless, transfer to a performing third party should not qualify as an event of default that triggers termination rights. These necessary restrictions on contractual rights are balanced by safeguards for counterparties to prevent authorities from splitting linked liabilities, rights and contracts: under a partial property transfer, linked arrangements should either all be transferred or not transferred at all. Arrangements include close-out netting agreements, set-off arrangements, title transfer financial collateral arrangements, security arrangements and structured finance arrangements.

65. In the light of these broad resolution tools and powers, it is expected that the decisions and actions taken by the resolution authorities should be subject to judicial review. However, in order to ensure stability of the financial system and the efficiency of resolution process, the scope of the judicial review should be limited to the legality of the action and to the award of compensation for the damages suffered by the affected persons.

#### *Funding Arrangements*

66. The funding of the resolution is vital to preserve the functioning of the systemically

important part of a failing bank. Moreover, the effective application of certain resolution tools requires short-term funding, for instance, to provide necessary funding or capital for a bridge institution or the provision of guarantees to potential purchasers. In this regard, it is necessary that member states establish financing arrangements to avoid the use of national budgets to finance resolution. The proposed Directive aims to establish arrangements for financing resolution measures, i.e., a European System of Financing Arrangements that consists of national financing arrangements, the borrowing between national financing arrangements and the mutualisation of national financing arrangements.

67. Accordingly, each member state should set up resolution financing arrangements to ensure efficient implementation of resolution tools and powers. These arrangements should solely be used in accordance with the resolution principles and objectives. 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.

68. 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. In parallel to this provision, national financing arrangements are obliged to lend to other financing arrangements within the EU under certain conditions. 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. In this regard, the group level resolution authority, in consultation with the other relevant resolution authorities, should establish a financing plan determining the total financial needs for the financing of the group resolution as well as the modalities for that financing.

## **Resolution Framework in Australia**

69. The Government enacted legislations in 2008, 2009 and 2010 to strengthen its prudential regulatory framework as well as the crisis resolution powers available to the Australian Prudential Regulation Authority (APRA). The legislation also includes with respect to powers of direction, business transfer powers, statutory management for authorised deposit-taking institutions (ADIs), and judicial management for general and life insurers.

Presently, APRA is Australia's prudential supervision authority and the primary agency responsible for the resolution of distressed ADIs and insurers. Accordingly, the APRA can facilitate recapitalisation of a distressed ADI or insurer without requiring the shareholders consent. It can also appoint a statutory manager to assume control and implement a wide range of open and closed resolutions. The APRA is also empowered to establish a bridge ADI or insurer.

70. The Australian Government has released a consultation paper in September 2012 with proposals for further reforms to APRA's crisis management powers. Though APRA has the powers to authorise a Non-Operative Holding Company (NOHC), it is not empowered to appoint a statutory manager (SM) to an ADI's NOHC and cannot apply to the Court for the appointment of a judicial manager (JM) to an insurer's authorised NOHC. Similarly, APRA does not have the power to appoint a SM to the subsidiaries of an ADI or of an authorised NOHC, and does not have the power to apply to the Court for the appointment of a JM to the subsidiaries of an insurer or of an authorised NOHC. In order to effectively and quickly resolve the distress of a financial group, with a minimum cost to the taxpayer, the Government has set out various proposals to broaden the scope of its resolution regime to the authorised NOHC and the subsidiaries of an authorised NOHC and of a regulated entity. The proposals, among others, include:

- enhancing and strengthening APRA's decision making powers, including appointment of SM or JM, over authorised NOHCs and related entities including insurers, and the subsidiaries of an authorised NOHC and of a regulated entity – including in a receivership or liquidation situation;
- empowering APRA to impose temporary stay on claw back provisions relating to financial support provided by an authorised NOHC or member of a regulated entity's group to a regulated entity as part of the resolution process and the authorised NOHC or the member subsequently been placed into insolvency administration;
- providing APRA with a specific direction power to temporarily suspend an entity's continuous disclosure obligations of information in certain circumstances for a limited period (capped at 48 hours);
- protection to directors and other officers of a regulated entity, authorised NOHC or subsidiary from any civil or criminal liability arising out of compliance of directions given by APRA;
- empowering APRA to direct a regulated entity, authorised NOHC and subsidiaries for facilitating preparation for a resolution of an entity's distress, including making specified changes to its systems, functionality, operations and group structure;

- empowering APRA to apply business transfer tool in resolution of a general insurer or life insurer, as already applicable in case of ADIs, to another body corporate;
- extending the scope of resolution regime to foreign ADIs operating in Australia;
- enabling APRA to revoke authorisation of a foreign ADI or insurer operating in Australia where the foreign regulated entity's authorisation has been revoked in its home jurisdiction;
- empowering APRA to issue directions to the foreign insurers operating through branches in Australia not to transfer its Australian assets to an offshore head office or sister branch, and also not to transfer liabilities into the Australian branch, in line with the existing powers in case of foreign ADIs;
- expanding the scope of Financial Claims Scheme to insurers in case of application made by APRA for winding up the insolvent general insurer; and
- extending the crisis management powers of APRA to FMIIs.

## Germany

71. The German Restructuring Act, enacted on January 1, 2011, included three main elements for restructuring entities: (i) procedural provisions for a two-stage restructuring procedure for credit institutions; (ii) regulations regarding the transfer powers; and (iii) establishment of a Restructuring Fund.

### *Restructuring procedure*

72. The Act introduced two procedures that could be applied to distressed credit institutions. These include: (i) restructuring procedure, and (ii) reorganisation procedure. Both procedures can be initiated only by the concerned credit institution at its own discretion. Under the restructuring procedure, which does not affect third party rights, the Federal Financial Supervisory Authority (BaFin) assesses the proposed restructuring plan as regards its plausibility, implementation and compliance with legal requirements. On a positive assessment, the BaFin submits the plan to the Higher Regional Court. The reorganisation procedure is applied if the credit institution is of the belief that there are no alternatives or the stability of the financial system is at risk and could affect the third party rights (e.g. liquidation, deferral or partial write-down of liabilities, debt to equity swaps, share capital reduction, capital increase, etc.).

### *Transfer Order*

73. The German Banking Act empowers BaFin to issue Transfer Order for transferring the whole business, or a partial transfer of assets and liabilities, of credit institutions in case

the non-viability of the bank presents a risk to the stability of the financial system, without the consent of the bank's management, creditors and shareholders. The Financial Market Stabilisation Authority (FMSA), in coordination with BaFin, is responsible for measures, including the establishment of bridge bank, necessary to give effect to the transfer of the failed institution to the bridge bank and the valuation of assets.

### *Restructuring Fund*

74. A Restructuring Fund, to be administered by the FMSA, has been set up with contribution from all credit institutions and is used for the purpose of orderly resolution, including establishment of bridge banks, acquisition of shares, issue guarantees and adopt recapitalisation and other measures.

## **Switzerland**

75. Following the financial crisis, the Swiss Banking Act was revised in 2011 and 2012 to include specific requirements for resolution of systemically important banks and additional restructuring mechanisms. The Banking Act provides for early intervention rights and an accelerated restructuring and resolution procedure under the lead of Financial Market Supervision Authority (FINMA) acting as resolution authority for banks and securities dealers including, in particular, bail-in powers and powers to transfer asset and liabilities to another legal entity. FINMA generally follows a Single Point of Entry (SPE) resolution strategy for bail-in of problem G-SIBs and focuses on the parent bank and, where appropriate, also the highest-level non-operating holding company. The strategy provides for shareholders and creditors at the highest level of the financial group to bear the losses while business operations are maintained. The group is recapitalised so as to make thorough restructuring possible. The group structure remains intact, business operations continue without interruption, and the continuity of economically critical functions is assured. Recapitalising via bail-in buys time to address the necessary adjustments to the business model.

76. FINMA has the powers to impose temporary stay on the early termination of financial contracts for a maximum of 48 hours, after which the counterparties are entitled to make use of their contractual termination rights to the extent that there has been a subsequent default. While in case of restructuring and liquidating banks, the courts have powers to deal with creditors challenges on FINMA's decisions, in case of systemically important banks the power is limited to ensuring the ex-post balancing of interests, e.g. by means of a compensation for a specific set of creditors. This would necessarily mean that the FINMA's decisions cannot be reversed by the Courts.



77. The resolution action is triggered, in case of banks in Switzerland, when there are reasonable grounds for suspecting that a bank is over-indebted or experiencing serious liquidity problems or when it fails to meet its capital adequacy requirements within a deadline set by FINMA, referred to as 'Point of non-viability (PONV)'. The capital trigger is activated for the financial group on a consolidated basis or at the individual parent bank entity level at the latest when total capital reaches 8% of the risk weighted assets or when the CET1 reaches or falls below 5% of the RWA. However, FINMA has certain discretion in determining whether or not the trigger is hit.

78. FINMA decides to activate bail-in powers in respect of a bank in case it considers that there is a clear prospect of a successful bail-in restoring market confidence and returning the restructured bank to a "business-as-usual" mode. As per Swiss Special Resolution Regime for banks, all claims, except those that are clearly defined, are subject to the regime of compulsory conversion of debt into equity or compulsory write-down of claims. However, all privileged claims, i.e. claims of employees, insured deposits up to the limit of the guarantee of 100,000 Swiss Francs per depositor, secured claims and claims subject to offset, are not eligible for activation of bail-in or subject to a haircut. This means that the uninsured deposits are also potentially subject to bail-in, but only if all other debt has already absorbed losses.

79. In a restructuring, any creditor has to receive at least what he would have received in liquidation. If the "no creditor worse off" principle does not lead to a positive result, the creditors who are worse off would have to be compensated ex-post.

80. The primary resolution objective of the Swiss authority is to rescue the problem bank by triggering the 'bail-in' and if it is not possible, then the emergency plan would be executed to protect critical functions. These functions would be maintained, sold off or wound down in an orderly manner. The remaining parts which are not systemically significant will be wound down or subject to liquidation.

## Netherlands

81. The Dutch resolution framework was broadened to address the risks posed by systemically relevant banks. The Dutch Intervention Act for Financial Institutions authorises the Dutch Central Bank (DNB) to issue a Transfer Plan for transfer of a problem bank or insurance company, when a bank or insurance company faces difficulties relating to solvency, liquidity or compliance with regulatory technical provisions and cannot be reversed

in a timely manner. The resolution powers of DNB are limited to banks and insurers, and do not apply to foreign branches of European Economic Area (EEA) banks or to securities or investment firms or financial market infrastructure. The scope of application is not limited by an institution's size or systemic importance. However, the systemic relevance of failure is considered when selecting resolution options.

82. The Minister of Finance is empowered to intervene, if the financial stability of the financial system is at risk, in a financial firm or its parent company or expropriate assets or liabilities of a bank, insurance company or any other financial firm or the parent company. The resolution powers of the Dutch Minister of Finance apply to all financial undertakings, i.e. banks, management company, collective investment scheme, investment firm, payment service provider, depository, clearing institution, risk accepting entity, financial service provider, financial institution, pension depository, insurer or a money transaction office.

## Spain

83. Following the financial crisis, the Spanish Government strengthened the deposit insurance agency (FGD) to extend its powers to provide financial support in resolution, and in June 2009 created the Bank Resolution Authority (FROB) to assist the reorganisation of the banking industry. In addition, the Government of Spain enacted a new legal framework for bank resolution on August 31, 2012. The framework aims at improving the resolution regime that had been in force since 2009, and takes into account the EU legislative proposal on the recovery and resolution of banks and investment firms. Under the new framework, the FROB will be able to provide temporary financial support for the restructuring and resolution of problem banks. The support may take the form of guarantees, loans subordinated debt, or acquisition of assets or capital injections. The FROB has various resolution tools at its disposal, that include sale to a third party purchaser, transfer of assets to a bridge bank or Sareb (an asset management company), and liability management exercises, and also to take over managerial functions of banks in resolution. However, the resolution can be triggered only by the supervisory authority, who also happens to be the authority for approving the resolution plan.

### Thematic Peer Review on Resolution Regimes - Highlights

1. The Financial Stability Board (FSB) conducted its first thematic peer review of all FSB member jurisdictions (24 countries) to evaluate their existing resolution regimes and any planned changes to those regimes using the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (the Key Attributes) as a benchmark. The review provides a comparative analysis of the overall legal, institutional and policy framework of existing resolution regimes, both across individual Key Attributes and across different financial sectors (banking, insurance securities or investment firms and financial market infrastructures (FMIs)). The review focuses primarily on those Key Attributes that cover the core provisions of national resolution regimes applicable to any financial institution that could be systemically important or critical if it fails.

#### Scope of resolution regime

2. All FSB jurisdictions have resolution regimes with specific powers to restructure and/or wind up banks. These resolution regimes in most of the jurisdictions apply principally to deposit-taking institutions (mainly to commercial banks and other deposit-taking institutions). 8 jurisdictions<sup>1</sup> use certain powers specifically to systemically important banks. 21 jurisdictions<sup>2</sup> also have specially adapted insolvency regimes for insurance firms that rely on combination of ordinary insolvency law supplemented by powers for supervisory authorities. While 13 jurisdictions<sup>3</sup> have specific powers to restructure and/or wind up securities or investment firms outside the ordinary corporate insolvency laws, only 8 jurisdictions<sup>4</sup> have sector-specific powers for all or some classes of FMIs.

3. The range of powers available in many jurisdictions in respect of insurers, securities or investment firms and FMIs are not aligned with the KAs and they are either supervisory in nature and require shareholders' consent or are limited to liquidation and winding up at the initiative of the supervisors, or in some cases through some form of specially adapted insolvency regime.

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<sup>1</sup>Germany, Indonesia, Japan, Netherlands, Russia, Switzerland, UK and USA. In the case of Netherlands and US, these powers apply to all SIFIs, including non-bank FIs.

<sup>2</sup>Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, Italy, Japan, Korea, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, Spain, Switzerland, Turkey, UK and US.

<sup>3</sup>Brazil, China, France, Italy, Korea, Russia, Netherlands, Saudi Arabia, Spain, Switzerland, Turkey, UK, US.

<sup>4</sup>France (only CCPs), Germany, Italy, Netherlands, Russia, Switzerland (if having a banking license), UK (only CCPs), US (systemic FMIs).

4. Majority of jurisdictions have specific powers to restructure and wind up holding companies that are regulated as banking or insurance groups. However, only eight jurisdictions<sup>1</sup> of them have the ability to use those powers for financial holding companies (FHCs) that are not bank or other regulated institution. In most of the jurisdictions, the resolution regime cannot be applied to non-regulated operational entities within a financial group. Only seven jurisdictions<sup>2</sup> have direct powers in relation to non-regulated operational entities that can be exercised in the resolution of whole or a part of the financial group or conglomerate. A majority of jurisdictions have powers over branches of foreign financial institutions. The powers in respect of foreign branches are much less comprehensive than those available for locally incorporated entities.

## Resolution Authority

5. All FSB member jurisdictions have conferred responsibility and powers for the resolution of financial institutions to one or more public authorities. Majority of jurisdictions<sup>3</sup> confer the primary responsibility and powers for the resolution of banks on supervisory authorities. For the insurance sector, almost all jurisdictions have prudential supervisors that can intervene in failing institutions in a variety of ways (such as license withdrawal, appointment of administrator, or court petition for winding up), although most of them require the courts to appoint an administrator or liquidator to carry out the resolution. Majority of the jurisdictions<sup>4</sup> do not have any administrative authority responsible for restructuring and winding up securities or investment firms and FMIs. This indicates the limited scope and powers for resolving systemically important non-bank SIFIs under the existing regimes.

6. Only nine jurisdictions<sup>5</sup> have a single resolution authority for resolution of all types of financial institutions, but there is certain kind of coordination mechanism with sector regulators. In jurisdictions with multiple resolution authorities, though they have some form of coordination arrangements in place between the authorities, several jurisdictions, except a few, do not appoint any 'Lead Authority' to coordinate the resolution of domestic entities of the same financial group.

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<sup>1</sup>Brazil, France, Germany, Italy, Korea, Netherlands, UK, US.

<sup>2</sup>Brazil, Italy, Saudi Arabia, Spain, Switzerland, UK, US.

<sup>3</sup>Argentina, Australia, Brazil, China, France, Germany, Hong Kong, Italy, Japan, Netherlands, Russia, Saudi Arabia, Singapore, Switzerland and Turkey. In Indonesia, resolution functions are divided between the supervisory authority and the deposit insurance agency. In UK, the resolution powers are conferred on the Central Bank (or the Treasury in case of Temporary Public Ownership), while the supervisory authority (PRA) is an operationally independent subsidiary of central bank.

<sup>4</sup>Argentina, Australia, Canada, Hong Kong, India, Indonesia, Japan, Mexico, and Singapore. Germany has no dedicated resolution authority for securities or investment firms. Brazil, China, Korea, Saudi Arabia, South Africa, Spain and Turkey have no dedicated resolution authority for FMIs.

<sup>5</sup>Australia, France, Germany, Italy, Japan, Singapore, Switzerland, UK and USA.

7. Almost all jurisdictions do not have statutory objectives in place for their resolution authorities in line with the Key Attributes. Although nearly all authorities have formal objectives to maintain financial stability and protect depositors or policyholders, many do not have mandates to avoid destruction of value or to consider the impact of resolution actions on other jurisdictions.

## Resolution triggers

8. Most of the jurisdictions' resolution regimes provide for timely entry into resolution or the exercise of resolution powers at or before the point of non-viability, and before the firm is balance-sheet insolvent. In most cases, the non-viability triggers for insurers, securities or investment firms and FMIs apply later than for banks, possible due to the fact that they reflect triggers available under corporate insolvency regimes.

## Resolution powers

9. The resolution powers in most FSB jurisdictions are considerably more developed for banks than for insurance and, especially, for securities or investment firms and FMIs. Majority of the FSB jurisdictions have power to appoint an Administrator with varying powers, powers to transfer assets and liabilities from a failed bank (in many cases, these powers are exercised by the Administrator), powers to establish and operate a bridge institution in case of failed banks, powers to establish asset management company. A few jurisdictions<sup>1</sup> have bridge powers for insurers, securities or investment firms or FMIs. Only two jurisdictions (Spain and Switzerland) have bail-in powers conferred by their statutes on their resolution authority, while US is able to write down or convert liabilities within resolution using other powers. Powers for a resolution authority to write down and convert liabilities are generally not available for insurers, securities or investment firms and FMIs. At least one of the two specific resolution powers for insurers (portfolio transfer and 'run-off') is available in nearly all FSB jurisdictions<sup>2</sup>.

10. The resolution powers are distributed across two or more authorities in many of the jurisdictions. In most of the jurisdictions, the exercise of resolution powers may require a court order or confirmation, which is not against the Key Attribute, but could impede the timely resolution action.

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<sup>1</sup>Australia (insurers), Japan (insurers), Saudi Arabia (insurers), US (insurers, securities/investment firms and FMIs).

<sup>2</sup>Australia, China, France, Germany (portfolio transfer for life and health insurance only), Italy, Korea, Mexico (run-off by liquidator), Netherlands (run-off by court), Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, UK, US.

## Set-off, collateralization, segregation of client assets

11. Only four jurisdictions (Canada, Spain, Switzerland and US)<sup>1</sup> provide for imposition of a temporary stay on the exercise of contractual acceleration or early termination of rights in financial contracts involving banks. However, only 3 jurisdictions (Spain, Switzerland and US) provide for safeguards for counterparties to financial contracts. Several other FSB jurisdictions, however, have other forms of stay, such as an indefinite stay triggered by entry into insolvency or resolution but without special treatment for financial contracts, but these lack features of Key Attributes.

## Safeguards for creditors affected by resolution actions

12. The legal frameworks of all jurisdictions, except Canada, Germany, Turkey and US, require resolution authorities to respect the hierarchy of claims in resolution. However, only five jurisdictions<sup>2</sup> have the power to depart from the general insolvency principle of equal treatment of creditors of the same class, for reasons of financial stability. Only seven jurisdictions<sup>3</sup> provide an explicit statutory right to compensation for any creditor that is worse off in resolution than in normal liquidation. This right is particularly relevant where the regime permits departure from the principle of equal treatment of creditors of the same class. Majority of jurisdictions provide a right to judicial review either under general administrative law or as an explicit right under the resolution regime and, in most cases, remedies other than monetary compensation are available. In such cases, the legal framework needs to strike an appropriate balance between legal remedies on one hand and the certainty of resolution action on the other.

## Funding of institutions in resolution

13. Three jurisdictions<sup>4</sup> have privately funded dedicated resolution funds, while 15 jurisdictions<sup>5</sup> have deposit insurance system (funded either ex-ante or ex-post by industry levies) that may be drawn on to fund bank resolution, in addition to pay-out. Where deposit

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<sup>1</sup>Under the US framework, the temporary stay is statutory and applies in all cases rather than it being a discretionary power of the resolution authority. In UK and Dutch resolution regime, the Bank of England and DNB respectively have the power to prohibit the exercise of early termination rights in connection with an exercise of transfer powers. However, that power is limited to termination rights under contracts that are not covered by the EU Financial Collateral Directive, which currently prevents EU member states from staying rights under financial collateral arrangements. The draft EU Directive on bank recovery and resolution is expected to remove that obstacle.

<sup>2</sup>Australia, Canada, Germany, UK and US.

<sup>3</sup>Australia, Canada, Germany, Spain, Switzerland, UK and US.

<sup>4</sup>Germany (for limited purposes), Japan, and USA (the Orderly Liquidation Fund is initially funded by the US Treasury, which then gets repaid from asset resolution and the industry over a period of 5 years).

<sup>5</sup>Argentina, Brazil, Canada, France, Indonesia, Italy, Japan, Korea, Mexico, Netherlands, Russia, Spain, Turkey, UK, and US

insurance fund is being used for funding resolution, there are limitations to which those funds may be used or caps in the amount that can be used for a specific resolution (e.g. not more than the amount that would have been available to pay out depositors). However, in certain jurisdictions like Belgium, Hong Kong, India, Singapore, Sweden and Switzerland, deposit protection schemes cannot be used to fund resolution measures, except indirectly to fund the repayment of retail deposits.

14. Policyholder or investment protection funds have been established in some jurisdictions but play a limited role in funding resolution for insurance or securities or investment firms. 14 jurisdictions<sup>1</sup> have a protection fund for insurance policyholders or investors, but several of them restrict its use for compensation of policyholders or investors in a liquidation scenario and do not allow the fund to be used for financing resolution. No jurisdictions have a resolution fund dedicated to FMIs.

15. Mechanisms for recovery of public funds from shareholders, participants, creditors of the failed firm, or the wider financial industry are not developed, although several jurisdictions (Australia, Netherlands, USA) have facilities for levies to recoup on an ex-post basis any public funds used in resolution.

## **Legal framework for cross border cooperation**

16. National legal frameworks for cross-border cooperation in resolution are less well developed across all sectors than other areas of Key Attributes. The legal framework of most jurisdictions neither requires nor prohibits cooperation with foreign resolution authorities. Eight jurisdictions<sup>2</sup> have statutory provisions that explicitly empower or strongly encourage resolution authorities to cooperate with foreign authorities, while several others indicate that it is their policy to cooperate where possible. No jurisdiction has comprehensive obligations for domestic authorities to avoid taking resolution actions that may have an adverse effect on the financial stability of other jurisdictions. Authorities in EU member states are required to consider the impact of their actions on financial stability in other EU states.

17. While the legal frameworks in the majority of FSB jurisdictions do not provide for differential treatment of creditors (including depositors and policyholders) by location of their claim or the jurisdiction in which the claim is payable, there is provision for differential

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<sup>1</sup>Australia, Canada, China, France, Germany, Hong Kong, Italy, Japan, Korea, Singapore, Spain, Turkey, UK, and US.

<sup>2</sup>Australia (trans-Tasman cooperation with New Zealand), Hong Kong, Indonesia, Japan, Spain, Switzerland, UK, US

treatment of certain claims – in most cases, deposits – under the insolvency or resolution regime of eight jurisdictions<sup>1</sup>.

18. Only the national resolution authority of Switzerland has the power to recognise the transfer by the home country resolution authority of local assets and liabilities of a foreign bank, and make that transfer effective under local law. In Canada, the exercise of resolution powers by foreign authorities in other countries will have no effect in Canada unless approval or recognition is given by a Court in Canada.

19. Most jurisdictions report that they have some powers over branches of foreign banks. However, in most cases, those powers stem from the domestic insolvency framework or are much less comprehensive than the powers available for locally incorporated banks.

## **Resolvability assessments**

20. Only one jurisdiction (Switzerland) has in place a formal statutory requirement for resolvability assessments to be carried out. However, a majority of jurisdictions have shown their intention to undertake resolvability assessments as a core part of domestic resolution planning framework. Where resolvability assessments are being carried out or planned, the focus is generally on global or domestic systemically important banks rather than on a wider range of FIs. Only two jurisdictions<sup>2</sup> currently require resolvability assessments for institutions from other financial sectors.

21. In most FSB jurisdictions, supervisory authorities have some powers to ask supervised institutions to make changes to their business organization and legal structure, but the purposes for and circumstances under which authorities can exercise such powers vary across jurisdictions and financial sectors.

## **Recovery and Resolution Planning**

22. Currently, only four jurisdictions<sup>3</sup> have formal statutory requirements for development of RRP, and many other jurisdictions are in the process of developing such plans for G-SIBs and D-SIBs. Jurisdictions that are home authorities of G-SIBs have started working on the development of RRP through supervisory policy and many jurisdictions have asked firms to prepare recovery plans under existing supervisory powers. However, the RRP is

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<sup>1</sup>Australia, (depositors and insurance policyholders), Indonesia, Japan, Korea (depositors), Singapore, Switzerland, Turkey (depositors), US (depositors).

<sup>2</sup>UK (for large investment firms) and US (for non-bank SIFIs).

<sup>3</sup>Spain, Switzerland, UK and US.



predominantly focused on banks. Only two jurisdictions (UK and US) have a framework for RRP for other categories of financial institutions, while Canada is developing RRP for insurers under general supervisory powers.

## **Access to information and information sharing**

23. Domestic authorities with resolution functions are generally able to share non-public information with each other. This general principle is subject to a few exceptions, where the sharing of confidential information with non-supervisory domestic authorities for both planning and carrying out resolution is either not permitted (Brazil); limited to specific circumstances, such as the entry of a firm into resolution (Italy) or conditional on a decision to undertake a resolution involving public funds (Switzerland).

24. Cross-border information sharing is considerably more restricted. Eight FSB jurisdictions<sup>1</sup> allow domestic authorities to share non-public information with foreign resolution authorities that are not supervisors. In many cases, information can be shared cross-border between supervisory authorities using existing supervisory gateways, but not as readily through other channels (Argentina, Mexico, Russia, South Africa, Turkey). Supervisory gateways are not, however, sufficiently broad to allow confidential information to be shared with all foreign authorities that have a responsibility for planning or carrying out resolution of the firm in question.

25. In most cases, jurisdictions do not require a memorandum of understanding (MoU) as a condition for disclosure of information under existing gateways, but a number of jurisdictions indicated that a MoU was in practice a prerequisite or seen as desirable.

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<sup>1</sup>Australia, Canada, France (where foreign authorities have similar functions to ACP and are subject to equivalent standards of professional secrecy), Hong Kong (subject to specified conditions set out in the relevant legislation), Saudi Arabia, Spain (in the case of non-EU resolution authorities, where the receiving authority is subject to equivalent standards of professional secrecy), UK, US

### Draft Annex to the FSB Key Attributes: Resolution of Insurers

The FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (the Key Attributes) state that any financial institution that could be systemically significant or critical if it fails should be subject to a resolution regime consistent with the Key Attributes.

The systemic impact of an insurance failure can materialise in various ways, including through contagion (where policyholders or markets consider that similar problems may exist in similar products from other insurers) and financial links (for example, in the derivatives markets), and may have an impact on the broader economy through a failure to make good on promises to policyholders or to engage in new transactions that would foster economic activity.

The general assumption is that traditional insurance activities and even some non-traditional insurance activities that are no longer viable will typically be resolved through run-off and portfolio transfer procedures. It may not be possible, however, to rely on these tools in all circumstances, and particularly in those cases in which the business model, booking model or shared services model of a firm is complex. Run-off and portfolio transfer tools may not, for example, be sufficient to mitigate the systemic impact of a sudden deterioration in the viability of a larger, complex insurance group engaging in other non-traditional insurance and non-insurance activities that may involve some degree of bank-like leverage and maturity transformation. Insurance companies, insurance groups and insurance conglomerates, including reinsurance companies and reinsurance groups, (hereinafter “insurers”), that could be systemically significant or critical if they fail therefore should therefore be subject to resolution regimes that meet the standard set out in the Key Attributes.

This Annex provides guidance on the implementation of the Key Attributes in relation to resolution regimes for insurers. It supplements the Key Attributes by indicating how particular Key Attributes, or elements of particular Key Attributes, should be interpreted when applied to resolution regimes for insurers. The guidance on individual Key Attributes should be read in conjunction with the Key Attribute to which it relates.

## **1. Objectives**

1.1 A resolution regime for insurers should meet the general objectives set out in the Key Attributes (Preamble and Key Attribute 2.3). It should make it feasible to resolve an insurer without severe systemic disruption or exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation. Additionally the resolution regime should have as a statutory objective the protection of insurance policyholders, especially retail policyholders who are dependent on insurance benefit payments.

1.2 Functions provided by insurers that may constitute vital economic functions include risk transfer, risk pooling and the pooling of savings. The protection of these functions should include securing appropriate continuity of insurance coverage and payments.

## **2. Scope of resolution regimes**

2.1 Any insurer that could be systemically significant or critical if it fails and, in particular, all insurers designated as Globally Systemically Important Insurers (“G-SIIs”), should be subject to a resolution regime consistent with the Key Attributes.

## **3. Resolution authority**

3.1 As part of its statutory objectives and functions, the authority responsible for the resolution of insurers should exercise its resolution functions in a way that meets the relevant general objectives set out in the Preamble and Key Attribute 2.3 and the specific objective of protecting policyholders.

3.2 To achieve its objectives, the resolution authority may need to interact with applicable schemes for the protection of insurance policyholders (‘policyholder protection schemes’). The respective mandates, roles and responsibilities of the resolution authority and policyholder protection schemes should be clearly defined and coordinated.

3.3 The resolution powers may be exercised by the resolution authority directly or through a special administrator, receiver, conservator or other official subject to the same objectives as the resolution authority.

## 4. Resolution powers

### Entry into resolution (Key Attribute 3.1)

4.1 The resolution regime should set out clear standards or suitable indicators of non-viability to guide the decision as to whether an insurer meets the conditions for entry into resolution. Such standards or indicators should allow for timely and early entry into resolution before an insurer is balance-sheet insolvent. They may include a determination by the supervisory authority, in consultation with the resolution authority (where the supervisory authority is not also the resolution authority) that:

- (i) there is an unacceptably low probability that policyholders will receive payments as they fall due;
- (ii) there is an unacceptably low probability that policyholders receive payments of the total amount owed;
- (iii) recovery measures have failed to return the insurer to sustainable viability or have not been implemented in a timely manner;
- (iv) proposed recovery measures will not be sufficient to return the insurer to viability or cannot be implemented in a timely manner; and
- (v) the resolution objectives cannot be achieved through ordinary insolvency, run-off or portfolio transfer procedures alone.

### Choice of resolution powers

4.2 Resolution authorities should have at their disposal a broad range of resolution powers, but should in each case only use those powers that are suitable and necessary to meet the resolution objectives. The choice and application of the resolution powers provided for in KA 3 should take into account insurance specificities and, in particular, the types of business the insurer engages in and the nature of its assets and liabilities.

### Control, manage and operate the insurer or bridge institution (Key Attribute 3.2 (ii, iii and iv))

4.3 Resolution authorities should have the power to carry on some or all of the insurance business, either within the existing entity or using a bridge institution, with a view to maximising value for policyholders as a whole and providing continuity of insurance coverage, including the power to:

- (i) continue to fulfil in whole or in part existing obligations under contracts of insurance;
- (ii) permit the exercise of options under existing contracts of insurance, including the surrender or withdrawal of contract cash value;
- (iii) enter into new contracts of insurance and reinsurance; and
- (iv) buy reinsurance (or retrocession) coverage.

In each case, the costs of those obligations should be met either from the existing estate, the collection of premiums due, the collection of recurring premiums, the collection of new premiums or the support of the policyholder protection scheme.

#### Restructuring of liabilities (Key Attribute 3.2 (iii))

4.4 The resolution authority should have the power to restructure or limit liabilities, including insurance and reinsurance liabilities, and allocate losses to creditors and policyholders in a way consistent with the statutory creditor hierarchy, subject to the safeguards set out in Key Attribute 5. Examples of a restructuring of liabilities include, but are not limited to, the following:

- (i) reducing future (or contingent) benefits, such as the sum assured or the annuity provided, in a manner that allocates losses as appropriate to policyholders whilst maintaining continuity of insurance coverage and payments falling due;
- (ii) reducing the value of contracts upon surrender, where insurance contracts have a surrender value to enable losses to be imposed as appropriate on policyholders that seek to surrender their contracts;
- (iii) reducing or terminating guarantees, such as the guaranteed sum assured or annuity rate provided by a with-profits policy, to enable losses to be imposed on policyholders that participate in the profits and losses of the insurer (or a fund) as appropriate and remove uncertainty about the future value of such guarantees;
- (iv) terminating or restructuring options provided to policyholders, for example as part of a deferred or variable annuity contract (including to help facilitate a transfer);
- (v) converting an annuity into a lump sum payment that can be used to fund the issuance of a new annuity contract or be paid out to the policyholder in circumstances where continuity is not achievable;
- (vi) settling crystallised and contingent insurance obligations by payment of an amount calculated as a proportion of estimated present and future claims, to provide a more rapid and cost-effective resolution where future claims are uncertain and run-off is not feasible or there is not time to carry out a detailed actuarial valuation;
- (vii) converting insurance liabilities from one type of insurance liability into another (for instance 'with profits' into 'unit linked') in order to facilitate a sale of business or ensure its continuity;
- (viii) reducing the value of inwards reinsurance contracts or restructuring inwards reinsurance contracts, for example by imposing limits on a policy, to allow losses to be imposed on cedants, as appropriate and where this does not compromise financial stability. This includes obligations under inwards reinsurance contracts.

Where a restructuring of insurance liabilities takes place and the values of insurance contracts are reduced, that restructuring may provide for the values of insurance contracts to be increased later in relation to the performance of the business following resolution so that creditors (including policyholders) benefit from any upside in a way that respects the creditor hierarchy.

4.5 The resolution authority should be able to exercise powers of conversion or commutation, subject to the safeguards set out in KA 5, without being required to identify every creditor or potential creditor or to provide notice to each one.

4.6 The powers should allow resolution actions to be taken effectively and in a way that binds unknown creditors where:

- (i) claims have not yet arisen;
- (ii) claims have arisen but have not yet been notified;
- (iii) claims have not yet been estimated; or
- (iv) the identity of policyholders, claimants or beneficiaries is not known (for example because cover has been written by third parties and the claim investigation has not progressed to the point whereby all relevant parties have been identified).

#### Portfolio Transfer (Key Attribute 3.2(vi) and 3.7(i))

4.7 Resolution authorities should have the power to transfer contracts of insurance and reinsurance, including the power to vary or reduce the value of those contracts transferred. Where the value of the contract of insurance or reinsurance is uncertain or requires considerable time to evaluate, the power should provide for a pre-agreed mechanism to adjust the value of the contract after the transfer has been effected.

4.8 Resolution authorities should have the power to transfer any reinsurance associated with the transferred policies without the consent of the reinsurer.

#### Power to suspend insurance policyholders' surrender rights

4.9 In order to achieve an effective resolution, the power of the resolution authority to suspend creditor rights in resolution should extend to the ability to temporarily restrict or suspend the rights of insurance policyholders to withdraw from or change their insurance contracts with an insurer. The exercise of the power and duration of the stay should be appropriate to the nature of the insurance product (for example, the distinction between life and non-life insurance).

4.10 The resolution authority should have the power to stay rights of reinsurers of the firm to terminate coverage for periods relating to, or policies incepting, after the commencement of resolution. The resolution authority should also have the power to stay any right to no longer reinstate reinsurance cover upon payment of a premium; however, that power should be accompanied by an arbitration or compensation mechanism to determine a fair value of reinsurance premium to be paid in relation to the continued period of reinsurance coverage.

## **5. Safeguards**

### **Respect of creditor hierarchy and creditor status of policyholders**

5.1 The hierarchy of claims in liquidation should give a high priority to policyholder claims so that shareholders and unsecured creditors, such as debt holders, absorb losses before policyholders.

### **Pari-passu principle**

5.2 The flexibility for the resolution authority to depart from the general principle of equal (pari-passu) treatment of creditors of the same class may extend to the treatment of classes of policyholders if this is necessary to contain the potential impact of a firm's failure, maximise the value for creditors as a whole (including for policyholders) or to otherwise meet the objectives of resolution, subject to the “no creditor worse off safeguard” (Key Attribute 5.2). A resolution authority may define sub-classes of policyholders (for example, policyholders with the same insurance product or those covered by a policyholder protection scheme) and treat those sub-classes of policyholders differently in resolution. However, there should be no differential treatment of policyholders within the same sub-class (for example, same insurance product or policies).

### **No creditor worse off safeguard**

5.3 Any determination of whether any class or sub-class of policyholders is worse off as a result of resolution measures than in liquidation should take into account the applicable legal regime and the contractual terms and conditions under the insurance policies.

5.4 Authorities should clarify ex ante the method and as-of date by which claims in foreign currencies would be converted into the reporting currency of the failed entity.

## **6. Funding resolution**

6.1 Jurisdictions should have in place privately-financed policyholder protection schemes that can assist in:

- (i) securing continuity of insurance coverage and payments by the transfer of insurance policies to a bridge insurer or third party or use of any other resolution powers; and
- (ii) compensating policyholders or beneficiaries for their losses in the event of a wind-up or liquidation.

## **7. Cross-border effectiveness**

7.1 Where contracts are written under a governing law other than that of the jurisdiction where the insurer is located, authorities should be satisfied that the terms of transfer and liability restructuring conducted by the resolution authority will be effective, for example by including recognition clauses in the insurance contracts.

## **8. Crisis Management Groups (CMGs) and Cooperation Agreements (COAGs)**

8.1 Crisis Management Groups (CMGs) and institution-specific cooperation agreements (COAGs) should be maintained or developed at least for G-SIIs. They should build upon existing supervisory colleges and cooperation agreements.

## **9. Resolvability assessments**

9.1 All insurers that could be systemically significant or critical upon failure in a domestic or cross-border context, at a minimum all global systemically important insurers (G-SIIs), should be subject to regular resolvability assessments that are conducted in accordance with Key Attribute 10 and Annex II.

9.2 In undertaking a resolvability assessment to evaluate the feasibility and credibility of implementing the resolution strategy and operational resolution plan developed for the insurer, resolution authorities, in coordination with other relevant authorities, should assess in particular whether the chosen resolution strategy ensures the continuity of critical functions, including the continuity of coverage and payment for critical insurance contracts, and can be implemented without severe systemic disruption and without exposing taxpayers to loss.

9.3 The assessment of the feasibility of the resolution strategy should cover as appropriate:

- (i) the likely availability of a transferee or purchaser for any insurance business that is to be sold as part of the resolution strategy, taking into consideration the ability to use a bridge institution to operate the business on a temporary basis;



- (ii) the time needed to evaluate policyholder liabilities and the assets supporting, backing or to be transferred as consideration for assuming the liabilities, and for a potential buyer to carry out due diligence;
- (iii) the capacity of the policyholder protection scheme to fund its share of any transfer where there are insufficient assets to resolve all insurance liabilities in a timely manner;
- (iv) if the resolution strategy consists of or includes a solvent run-off, the risk that policyholders with later maturing policies may not receive their benefits in full and are 'time-subordinated' to those with earlier-maturing policies and short-term non-policyholder creditors;
- (v) the quality of management information systems and the documentation of insurance contracts, including the capacity of the firm to deliver detailed, accurate and timely information about the types of insurance business it undertakes, the number and type of policyholders, the benefits due to each policyholder, the reinsurance in place and information about assets, especially assets backing the insurance liabilities;
- (vi) the extent to which corporate structures and business units are aligned with legal entities to ensure that the sale, transfer or wind down of different business units can be accomplished through control of a single corporation or closely related group of corporations;
- (vii) the extent to which corporate capital structures would permit a bail-in within resolution in accordance with Key Attributes 3.5 and 3.6;
- (viii) the legal, operational and financial separateness of traditional insurance business from non-traditional insurance and non-insurance business;
- (ix) intercompany service agreements to ensure continuity of services;
- (x) the effect of intra-group transactions (for example, reinsurance transactions, loans or letters of credit, collateral upgrades or other liquidity support provided to banking entities, guarantees or letters of support, cost sharing or profit and loss-sharing agreements among affiliates) in resolution;
- (xi) the extent to which any interconnections or interdependencies between group entities or with third-parties affect the implementation of the resolution strategy;
- (xii) how contractual termination events (including cross-default) in financial contracts with insurers are defined, including whether rating down-grades, restructuring or (solvent or insolvent) run-off, in particular if occurring in a single legal entity within an insurance group, could trigger early termination of contracts of the relevant legal entity or its affiliates; and
- (xiii) whether surplus assets in other jurisdiction may be ring fenced in resolution.

9.4 When assessing the credibility and overall impact of implementing the resolution strategy, consideration should be given to its effects on third parties and financial stability as a whole, including whether the resolution of the insurer would cause:

- (i) a material adverse impact on economic activity as a result of any disruption to continuity of insurance cover and payment, which will be greatest when insurance is a pre-requisite to day-to-day economic activity (for example, employers' liability, trade credit and transport liability insurance); where a disruption in insurance claims and benefit payments is likely to cause significant and widespread financial hardship to households and businesses; or where the insurer has a significant share of the market;
- (ii) a lack of confidence in other insurers triggering a policyholder run, particularly where other insurers provide insurance that resembles on-demand savings products;
- (iii) an adverse impact on the resolvability of insurance or other financial operations undertaken elsewhere in the group;
- (iv) large investment losses for other financial institutions that could affect their capital resources;
- (v) the termination of securities lending and reverse repo operations that could affect funding and liquidity for other parts of the financial system; and
- (vi) an amplification of financial market disruption owing to the termination of financial guarantees or credit default swaps.

## **10. Recovery and resolution planning**

10.1 All insurers that could be systemically significant or critical upon failure, at a minimum all G-SIIs, should be subject to a requirement for an ongoing process of recovery and resolution planning.

10.2 Recovery and resolution plans (RRPs) need to be tailored to the specific risks and systemic implications that each insurer may be exposed to or create and take into account the types of business the insurer engages in, its derivatives booking, intercompany guarantees, inter-affiliate support arrangements, risk pooling, shared services and risk management model and the nature of its assets and liabilities.

10.3 A key component of RRPs is a strategic analysis that identifies the firm's essential and systemically important functions and sets out the key steps to maintaining them in both recovery and resolution scenarios. Elements of such analysis should include identification of essential and systemically important functions, mapped to the legal entities in which they are conducted. Such essential functions could include, but are not limited to:

- (i) the provision of critical types of insurance policies, the continuity of which is a priority in resolution for reasons of policyholder protection or financial stability;
- (ii) the provision of services (actuarial, claims handling, policy administration, benefit payment, etc.) that are necessary for the continuation of the critical insurance business;
- (iii) essential hedging activities that are necessary to the continuation of the insurance business (for example, hedging for variable annuities with complex embedded options and guarantees, or hedging to closely match annuity cash flows);
- (iv) liquidity or other funding support provided to other financial institutions, the sudden withdrawal of which could have adverse effects on financial stability;
- (v) intra-group transactions, for example, reinsurance (including captive reinsurance arrangements), funding, liquidity and intra-group support and guarantees, that are essential to the continuation of critical functions elsewhere in a group structure or that could otherwise significantly affect resolution or recovery if they are disrupted or suspended; and
- (vi) credit or financial guarantee insurance, or non-insurance (for example, CDS), the withdrawal of which could have adverse effects on financial stability or the broader economy.

### Recovery plans

10.4 Recovery plans should be developed on the basis of severe stress scenarios that combine adverse systemic and idiosyncratic conditions. They need to take into account insurance specificities such as the longer pay-out duration and the liquidity profile of insurers.

10.5 The insurer's direct supervisory authority, the policyholder protection scheme and relevant resolution authorities should cooperate in the review of the insurer's recovery plan.

10.6 In the case of G-SIIs, the review of the recovery plan should be carried out within the insurer's CMG.

10.7 Firms should identify possible recovery measures and the necessary steps and time needed to implement such measures and assess the associated risks of implementation. The range of possible recovery measures could include:

- (i) actions to strengthen the capital situation, for example, recapitalisations after extraordinary losses, capital conservation measures such as suspension of dividends and payments of variable remuneration;

- (ii) triggering of contingent capital instruments;
- (iii) possible sales of subsidiaries, portfolios of insurance contracts, renewal rights and spin-off of business units;
- (iv) changes to the reinsurance programme;
- (v) changes to the investment strategy and hedging programme;
- (vi) changes to business mix, sales volumes and product designs, including options to close books of business to new underwriting;
- (vii) changes to underwriting and claims handling practices; and
- (viii) modifications to contract terms and conditions, the level of charges, fees and surrender payments, the amount and timing of any discretionary benefits and the operation of discretionary incentives to renew contracts (such as 'no-claims discounts' or contract renewals without new underwriting).

10.8 A firm in solvent run-off should have a scheme of operations plan that sets out how all liabilities to policyholders will be met in full as they fall due and should include, for example, details on how expenses can be reduced as business volumes fall.

#### Resolution strategies and plans

10.9 In the case of G-SIIs, the resolution strategies and plans should be developed within the insurer's CMG.

10.10 Resolution plans for insurers should contain the essential elements set out in Annex III and also include, as appropriate to the type of the insurer, the following:

- (i) identification of policyholders that protected by a policyholder protection scheme and policyholders that are not eligible for benefits from such schemes;
- (ii) the actuarial assumptions used for calculating insurance liabilities and an independent exit value actuarial valuation of the technical provisions (policyholder liabilities);
- (iii) review of asset quality and concentration issues;
- (iv) preparation of insurance portfolio transfers, including a determination of the acceptability of assets to be transferred to any insurer assuming liabilities in a portfolio transfer;
- (v) sources of funding, including those from a policyholder protection scheme;
- (vi) provision for continuity or an orderly winding down of any derivatives portfolio;
- (vii) details on the allocation of ceded reinsurance among the various legal entities and impact on the recovery levels;

- (viii) an estimate of the outcome for each class of policyholder upon winding up (the counter-factual to the resolution plan and the basis for 'no creditor worse off' considerations); and
- (ix) practical arrangements for ensuring continuity of coverage and payment under certain types of insurance policies.

## **11. Access to information and information sharing**

11.1 In order to facilitate the implementation of resolution measures, insurers that could be systemically significant or critical upon failure, including all G-SIIs, should be required to maintain information systems and controls that can promptly produce, both in normal times and during resolution, the relevant data and information needed for the purposes of timely resolution planning and resolution, for example in particular, on the following:

- (i) insurance activities where continuity of coverage and payment need to be maintained in resolution;
- (ii) details of eligibility for protection under policyholder protection schemes and scope of protection for eligible policyholders; and
- (iii) deposit-like products and other financial products that could be prone to runs.

## Prompt Corrective Action (PCA) Framework

### Reserve Bank of India PCA Framework for commercial banks

The Reserve Bank has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of three parameters, i.e. capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA), for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points. The PCA framework is applicable only to commercial banks and not extended to co-operative banks, non-banking financial companies (NBFCs) and FMI.

The trigger points along with structured and discretionary actions that could be taken by the Reserve Bank are described below:

#### 1. CRAR

- (i) **CRAR less than 9%, but equal or more than 6%** - bank to submit capital restoration plan; restrictions on RWA expansion, entering into new lines of business, accessing/renewing costly deposits and CDs, and making dividend payments; order recapitalisation; restrictions on borrowing from inter-bank market, reduction of stake in subsidiaries, reducing its exposure to sensitive sectors like capital market, real estate or investment in non-SLR securities, etc.
- (ii) **CRAR less than 6%, but equal or more than 3%** - in addition to actions in hitting the first trigger point, RBI could take steps to bring in new Management/ Board, appoint consultants for business/ organizational restructuring, take steps to change ownership, and also take steps to merge the bank if it fails to submit recapitalization plan.
- (iii) **CRAR less than 3%** - in addition to actions in hitting the first and second trigger points, more close monitoring; steps to merge/amalgamate/liquidate the bank or impose moratorium on the bank if its CRAR does not improve beyond 3% within one year or within such extended period as agreed to.

#### 2. Net NPAs

- (i) **Net NPAs over 10% but less than 15%** - special drive to reduce NPAs and contain generation of fresh NPAs; review loan policy and take steps to strengthen credit appraisal skills, follow-up of advances and suit-filed/decreed debts, put in place proper credit-risk management policies; reduce loan concentration;

restrictions in entering new lines of business, making dividend payments and increasing its stake in subsidiaries.

**(ii) Net NPAs 15% and above** – In addition to actions on hitting the above trigger point, bank's Board is called for discussion on corrective plan of action.

- 3. ROA less than 0.25%** - restrictions on accessing/renewing costly deposits and CDs, entering into new lines of business, bank's borrowings from inter-bank market, making dividend payments and expanding its staff; steps to increase fee-based income; contain administrative expenses; special drive to reduce NPAs and contain generation of fresh NPAs; and restrictions on incurring any capital expenditure other than for technological upgradation and for some emergency situations.

## **FDIC PCA Framework**

The PCA framework prescribes five levels of trigger points based on capital measures, i.e. total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio, for insured state-chartered non-member banks. The five PCA categories are (i) well capitalized, (ii) adequately capitalized, (iii) undercapitalized, (iv) significantly undercapitalized, and (v) critically undercapitalized.

### **(i) Well capitalized –**

- (a) Total risk-based capital ratio of 10% or greater; and
- (b) Tier 1 risk-based capital ratio of 6% or greater; and
- (c) Leverage ratio of 5% or greater.

### **(ii) Adequately capitalized -**

- (a) Total risk-based capital ratio of 8% or greater; and
- (b) Tier 1 risk-based capital ratio of 4% or greater; and
- (c) A leverage ratio of 4% or greater, OR a leverage ratio of 3% or greater if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank.

### **(iii) Undercapitalized -**

- (a) Total risk-based capital ratio of less than 8%; OR
- (b) Tier 1 risk-based capital ratio of less than 4%; OR
- (c) A leverage ratio of less than 4%, OR a leverage ratio of less than 3% if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank.

### **(iv) Significantly undercapitalized -**

- (a) Total risk-based capital ratio of less than 6%; OR

- (b) Tier 1 risk-based capital ratio of less than 3%; OR
- (c) A leverage ratio of less than 3%.

**(v) Critically undercapitalized -**

- (a) The tangible equity to total assets (leverage ratio) is equal to or less than 2%.

For insured branches of foreign banks, the PCA framework has prescribed five categories in terms of pledged assets and maintenance of eligible assets. These are described below:

**(i) Well capitalized -**

- (a) Maintains the pledge of assets as per FDIC Rules and Regulations; and
- (b) Maintains eligible assets at 108% or more of the preceding quarter's average book value of the branch's third party liabilities; and
- (c) Has not received any written notification from OCC to increase its capital or asset management requirements.

**(ii) Adequately capitalized -**

- (a) Maintains the pledge of assets as per FDIC Rules and Regulations; and
- (b) Maintains eligible assets at 106% or more of the preceding quarter's average book value of the branch's third party liabilities; and
- (c) Does not meet the definition of well capitalized branch.

**(iii) Undercapitalized -**

- (a) Fails to maintain the pledge of assets as per FDIC Rules and Regulations; OR
- (b) Fails to maintain eligible assets at 108% or more of the preceding quarter's average book value of the branch's third party liabilities.

**(iv) Significantly undercapitalized -**

- (a) Fails to maintain eligible assets at 104% or more of the preceding quarter's average book value of the branch's third party liabilities.

**(v) Critically undercapitalized -**

- (a) Fails to maintain eligible assets at 102% or more of the preceding quarter's average book value of the branch's third party liabilities.

On bank reaching the levels of undercapitalized, or significantly undercapitalized, or critically undercapitalized, automatic restrictions, as per provisions of Section 38 of FDI Act, are placed on the concerned bank in respect of (i) payment of capital distributions and management fees, (ii) the growth of assets, (iii) requiring prior approval of certain expansion proposals, (iv) requiring that the FDIC monitor the condition of the bank, and (v) requiring submission of a capital restoration plan.



In addition to the above restrictions and close monitoring, the significantly undercapitalized and critically undercapitalized banks are restricted to pay compensation to senior executive officers of the institution. The critically undercapitalized bank is, in addition to above, required to take prior approval from FDIC in respect of – entering into any material transaction other than in the usual course of business, such as any investment, expansion, acquisition, sale of assets, or other similar action; extending credit for any highly leveraged transaction; amending the institution’s charter or bylaws; making any material change in accounting methods; paying excessive compensation or bonuses; paying significantly high interest on new or renewed liabilities; making any principal or interest payment on subordinated debt beginning 60 days after becoming critically undercapitalized; and engaging in any covered transaction. In addition, FDIC may further restrict the activities of the critically undercapitalized bank.

## **Early Intervention Framework in Canada**

The Canadian framework of early intervention (issued by the Office of the Superintendent of Financial Institutions (OSFI)) consists of four stages (in addition to the “all normal” stage). Each stage is identified by a set of conditions and a number of options for supervisory measures. The framework also includes guidelines for the interaction between the authorities, including the Canada Deposit Insurance Corporation (CDIC).

### **(i) Stage 1 – Early Warning -**

- (a) The combination of the institution’s overall net risk and its capital and earnings compromises the institution’s resilience; and
- (b) The institution has issues in its risk management or has control deficiencies that, although not serious enough to present a threat to financial viability or solvency, could deteriorate into more serious problems if not addressed.

Supervisory actions include – meeting the bank’s management, conducting more frequent and intrusive on-site supervision, and requiring additional and more frequent reporting. The OSFI informs the CDIC about the institution’s position and actions intended to take. OSFI will also send intervention reports to the CDIC and they will hold joint meetings to discuss the risk profile of the institution.

### **(ii) Stage 2 – Risk to financial viability or solvency -**

- (a) The combination of the institution’s overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions which may pose a serious threat to its financial viability or solvency; and

- (b) The institution has issues in its risk management that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into more serious problems if not addressed.

Supervisory actions include – requiring the institution to rectify problems within a specified timeframe, requiring the institution’s external auditor to extend the scope of the review of the financial statements or to conduct other procedures as specified by the OSFI, or developing a contingency plan to enable the OSFI to take rapid control of the assets of the institution in case of rapid deterioration. At this stage, OSFI will inform the CDIC of results and data obtained from enhanced supervisory reviews, expanded audits, and enhanced monitoring. The OSFI and CDIC will commence contingency planning.

**(iii) Stage 3 – Future financial stability in serious doubt -**

- (a) The combination of the institution’s overall net risk, capital and earnings makes it vulnerable to adverse business and economic conditions which pose a serious threat to its financial viability or solvency; and
- (b) The institution has significant issues in its risk management or control deficiencies, which present a serious threat to financial viability or solvency, unless effective corrective action is promptly implemented.

Supervisory actions include – directing specialists to assess specific areas such as the quality of loan security, asset values, and sufficiency of reserves; enhancing the scope of business restrictions put on the institution; sending OSFI staff to the institution to monitor the situation on an ongoing basis; expanding contingency planning; and communicating to the management the importance of considering resolution options, including seeking a prospective purchaser. The CDIC and OSFI will discuss the situation of the institution in depth.

**(iv) Stage 4 – Non-viability/insolvency imminent -**

- (a) The institution has failed to meet regulatory capital requirements in conjunction with an inability to rectify the situation on an immediate basis;
- (b) The statutory conditions for taking control have been met; and
- (c) The institution has failed to develop and implement an acceptable business plan, resulting in either of the two preceding circumstances becoming inevitable within a short period of time.

At this stage, OSFI has determined that the financial institution will become non-viable on an immediate basis. The supervisory actions include – assuming temporary control or taking control of the assets; and requesting that the Attorney General apply for a winding-up order.

## **Early Intervention Framework in Denmark**

The Danish framework consists of five quantitative indicators. The supervisor is authorized to take remedial action in cases where the limits are breached. The five indicators are –

- (i) Aggregate sum of all large exposures must not exceed 125 per cent of the bank's core capital. (Large exposure is defined as the sum of exposures to a client or to a group of connected clients, if it exceeds 10% of the bank's core capital);
- (ii) Bank's lending growth must not exceed 20% per year;
- (iii) Amount of lending for real estate must not exceed 25% of total lending;
- (iv) Bank's funding ratio must not exceed 1. (Funding ratio is defined as aggregate lending divided by working capital (all shares, junior and senior debt, but excluding debt shorter than one year)).
- (v) Liquidity coverage, defined as retail deposits in relation to wholesale funding must be at least 50%. In addition, the LCR and NSFR prescribed by Basel III will apply for liquidity and funding.

# Recovery Plan – An Indicative Methodology for Banks

## Introduction

Recovery Plan is a plan, which needs to be developed and maintained in advance by the senior management of the specified bank, detailing the steps that it would adopt to enable it to take early action to restore its long-term viability if the bank's financial situation deteriorated due to the extreme stress conditions. These stresses could be caused by an idiosyncratic problem, a market-wide problem or a combination of both, and could extend beyond the current regulatory stress testing scenarios.

In the recovery phase, the bank has not yet met the conditions for resolution or entered the resolution regime. Therefore, the recovery plan should represent a reasonable prospect of recovery if appropriate recovery measures are taken.

The banks will be required to prepare recovery plans that is integrated within its overall risk management framework and processes, and can be implemented and executed in a timely manner in case of need. The recovery plan should include measures to reduce the risk profile of the bank and conserve capital, as well as strategic and radical options, such as the exiting particular lines of business, selling subsidiaries and restructuring of liabilities, or raising fresh capital, etc.

The formulation of the plan should take into account the nature, complexity, interconnectedness, level of substitutability and size of the concerned bank.

The recovery plan in respect of the bank 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 bank group remains a “going concern”.

The recovery plans could largely help supervisors/ regulators in identifying the appropriate actions that can restore the viability of banks at an early stage. As recovery plans would be prepared by banks, this process would also help them reviewing their operations, risks, and necessary actions in a problematic situation.

Recovery plans thus would increase the preparedness and awareness of both banks and their supervisors/ regulators for and about problematic financial situations. It is also very critical that the banks take necessary measures to ensure that there are no impediments to the implementation of the plan in situations of financial stress.

## **Key components of recovery plan**

The key components of recovery plan are given in **Appendix 5.1**. Banks should submit the information as a part of the recovery plan as detailed in the Annex.

### **Governance framework for the recovery plan**

While preparing the recovery plan, the banks will be required to plan in advance what it would do if it suffered a severe stress situation that could threaten its survival as a going concern. In doing so, the banks will be required to document a menu of various credible options from which it would select the most appropriate one depending upon the circumstances of the stress situation. As the recovery action will depend upon the kind and severity of stress situation, the bank is not required to rank these menus of credible options or to prepare a pre-determined programme of recovery actions.

The banks should have in place a robust governance structure and sufficient resources to support the recovery and resolution planning process. This includes clear responsibilities of business units, senior management up to and including board members. The banks should also identify a senior level executive responsible for ensuring that the institution is and remains in compliance with RRP requirements. The responsibility for developing and maintaining, and where necessary, executing the recovery plans would lie with the bank's senior management. In essence, the recovery plan should be subject to oversight and approval by the Board of Directors.

The recovery plan should be regularly reviewed and updated at regular intervals in case of occurrence of events that materially change the bank's business structure or operations, its strategy or aggregated risk exposure. The bank should also regularly review the exogenous and bank-specific assumptions a recovery plan is based upon and assess on an ongoing basis the relevance and applicability of the plans. It should ensure that the processes are in place for regular monitoring of early warning signals and triggers that prompt implementation of the recovery plan.

The bank should ensure that suitable processes are in place for timely decision-making and implementation of the recovery plan by its senior management and board of directors when triggers are breached.

The banks should have in place systems to generate on a timely basis the information required to support the recovery and resolution planning process to enable both the bank and the authorities to carry out recovery and resolution planning effectively. In addition, the bank should be able to draw up concrete bank-specific stress scenarios, including both idiosyncratic and market-wide stress and also be in a position to furnish the strategy and scenario analysis to the authorities on request. It should also be having the capabilities and position to carry out simulation or scenario exercises with home and host authorities to assess the feasibility and credibility of the RRP.

The banks should ensure that the recovery plan is integrated into its existing overall governance framework and processes.

The recovery plans would be submitted to the Reserve Bank of India, which will review the adequacy of the plan as a part of the overall supervisory process, and assess its credibility and ability to be effectively implemented.

### **Menu of key credible recovery options**

#### ***Linkage with existing prudential framework***

The Reserve Bank of India has issued a number of prudential policies/ guidelines which imbibe the banks to identify various types of risks to which they are exposed to, and measure, assess and monitor them so as to avoid the threat of non-viability in case of extreme eventualities. The Recovery and Resolution Plan needs to be seen as an extension of the existing prudential requirements. The recovery plan is not only identification of severe and plausible threat but also requires suitable and credible options to be in place for bringing back the institution to normalcy and financial continuity and viability. The resolution element, however, ensures an orderly failure of the bank in case of failure of the recovery options.

#### ***Capital Adequacy***

The extant prudential guidelines on capital adequacy prescribe the commercial banks in India to maintain a minimum capital to risk weighted assets ratio (CRAR) of 9 per cent on an ongoing basis. In order to address other risks exposed by the banks, in addition to the Pillar 1 risks (credit, market and operational risk) covered by CRAR, as also to address the possibility of some under-estimation of risks under Pillar 1 and the actual risk exposure of a

bank vis-à-vis the quality of its risk management architecture, the banks are required to make their own assessment of their various risk exposures, through a well-defined internal process [called as *Internal Capital Adequacy and Assessment Process (ICAAP)*], and maintain an adequate capital cushion for such risks. The ICAAP document should, *inter alia*, include the capital adequacy assessment and projections of capital requirement for the ensuing year, along with the plans and strategies for meeting the capital requirement.

Banks are also required to focus on effective and efficient capital planning, as well as long-term capital maintenance. An effective capital planning process requires a bank to assess both the risks to which it is exposed and the risk management processes in place to manage and mitigate those risks; evaluate its capital adequacy relative to its risks; and consider the potential impact on earnings and capital from economic downturns. A bank's capital planning process should incorporate rigorous, forward-looking stress testing,

The banks' capital plan should spell out the institution's objectives in regard to level of capital, the time horizon for achieving those objectives, and in broad terms, the capital planning process and allocate responsibilities for that process.

#### *Liquidity risk management*

The banks are required to establish a robust liquidity risk management framework, including a liquidity risk management policy spelling out the liquidity risk tolerance, funding strategies, prudential limits, systems for measuring, assessing and reporting/ reviewing liquidity, etc. The banks are also required to establish a funding strategy that provides effective diversification in the source and tenor of funding, and maintain ongoing presence in its chosen funding markets and counterparties, and address inhibiting factors. The banks should identify alternate sources of funding that strengthen their capacity to withstand a variety of severe bank specific and market-wide liquidity shocks.

The banks are stipulated to have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing severe disruptions in liquidity which might affect the bank's ability to fund some or all of its activities in a timely manner and at a reasonable cost. CFPs should prepare the bank to manage a range of scenarios of severe liquidity stress that include both bank specific and market-wide stress and should be commensurate with a bank's complexity, risk profile, scope of operations.

In addition, the extant prudential guidelines on liquidity risk management also prescribe banks to maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios.

### *Stress testing*

Stress testing has become an integral element of a bank's risk management system and is used to evaluate its vulnerability to certain unlikely but plausible events or movements in financial variables. The vulnerability is usually measured with reference to the bank's profitability and/ or capital adequacy. The results bring to the fore the inadequacies in management of various kinds of risks on the basis of normal business conditions and emphasizes the importance of robust risk management systems which factor-in a forward looking element and recognise the need to manage risks over the economic cycle.

Banks have been advised to put in place a Board approved "Stress Testing framework" to suit their individual requirements which would integrate into their risk management systems. Stress tests undertaken on a bank-wide basis enable the board and the senior management to assess the potential impact of the stress situations on the bank's earnings and capital position, and enable them to develop or choose appropriate strategies for mitigating and managing the impact of those situations. The framework also helps bank managements in understanding the bank's risk profile and adjusting it in accordance with their risk appetites.

Banks are required to identify the major risks to which they are exposed to with regard to their bank specific circumstances and portfolio. They should stress the relevant parameters at least at three levels of increasing adversity – minor, medium and major – with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to (a) meet the risk as it arises and for mitigating the impact of manifestation of that risk, (b) meet the liabilities as they fall due, and (c) meet the minimum CRAR requirements.

A few examples of stress factors/ scenarios include: domestic economic downturn, economic downturn of major economies to which the bank is directly exposed or to which the domestic economy is related; decline in the prospects of sectors to which the banks are having significant exposures; increase in level of NPAs and provisioning levels; unexpected deposit withdrawals on account of sudden loss of depositors' confidence; increase in level of rating downgrades; failure of major counterparties; timing difference in interest rate changes (repricing risk); unfavourable differential changes in key interest rates (basis risk); parallel/ non parallel yield curve shifts (yield curve risk); changes in the values of standalone and



embedded options (option risk); adverse changes in exchange rates of major currencies; decline in market liquidity for financial instruments; stock market declines; tightening of market liquidity; significant operational risk events, etc.

The remedial actions that are generally considered necessary to activate when the various stress tolerance levels are breached include:

- (a) Reduction of risk limits;
- (b) Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging;
- (c) Amend pricing policies to reflect enhanced risks or previously identified risks;
- (d) Augmenting the capital levels to enhance the buffer to absorb shocks;
- (e) Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, etc.

The linkage of the need for preparation of the recovery plan by banks and the existing prudential policies indicate the following:

- (i) The results of the stress testing exercises prompts the Board and the senior management to initiate certain potential management actions such as, reduce the risk of loss through better internal controls or robust management or through reduction in the particular risk exposure, risk mitigation techniques, etc. These management actions could also form a part of options in the Recovery Plan.
- (ii) The objective of stress testing requirements is that banks should understand fully their risks and the potential impact of stressful events and circumstances on their financial condition and viability. The recovery plan has a common objective with the stress testing towards restoring financial soundness and viability.
- (iii) Actions identified as part of a bank's capital planning and contingency funding plan may also be considered as options for the Recovery Plan. However, the recovery plan options/ actions need to be suitable both for milder stress scenarios as well as for severe stress scenarios. Therefore, the capital planning and contingency funding planning will not be sufficient for preparation of the recovery plan.
- (iv) The existing capital and liquidity stress testing requirements could serve as essential inputs for the preparation of recovery plan. However, the recovery plan will require banks to plan for additional recovery options in circumstances where more severe than the existing stress scenarios occur and affects the financial viability of bank. This is because the recovery plan should be such that it contains

all options that could be initiated in case of severest of severe stress scenarios to recover.

- (v) The recovery plan should, therefore, feature options that the firm would not consider in less severe circumstances, such as:
  - (a) disposal of business or entities;
  - (b) raising equity capital which has not been planned for in the bank's business plan;
  - (c) complete elimination of dividends and variable remuneration;
  - (d) debt exchanges and other liquidity management actions;
  - (e) sale of the whole bank to a third party; etc.
  
- (vi) The recovery plans should cover forward-looking stress scenarios to incorporate different possibilities of multi-level stress tests, changes in portfolio composition, new information and emerging risk possibilities. These are different from relying on the normal historical risk management or replicating previous stress episodes.
  
- (vii) The recovery plans should cover a range of stress scenarios with different severities including scenarios calibrated against the most adverse movements in individual risk drivers experienced over a long historical period, which may be up-scaled to cover the benign economic cycle.

#### *Reverse stress testing*

Reverse stress testing is an useful method for developing effective stress scenarios that are not identified through ordinary stress tests. Reverse stress testing basically assumes the failure of the business model and identifies circumstances in which this may occur, rather than testing for outcomes arising from changes in circumstances of different likelihoods. The purpose of the reverse stress test is to identify and consider scenarios that would lead to a bank's business model becoming non-viable. In the case of scenarios used for reverse stress-testing, the business model has already failed and recovery measures would not be effective.

The aim of recovery planning is to describe options to restore financial strength and viability when the bank comes under severe stress. Banks should, therefore, consider only those scenarios that could lead to "near default" (and not a "default" or resolution scenario as used in reverse stress-testing). The reverse stress tests should therefore be seen only as a starting point for developing scenarios to test the effectiveness of bank's menu of recovery options.

The banks should use an appropriate number of market-wide (systemic) stress scenarios and bank-specific (idiosyncratic) stress scenarios<sup>1</sup> to test the robustness of their recovery plans and to assess which options would be effective in a range of stress situations. These scenarios should address capital shortfalls and liquidity pressures, and be severe enough to be useful in establishing triggers, estimating impacts of adverse situations, and contemplating responses to remediate both slow-moving and fast-moving adverse situations. It may be useful for a bank to combine market-wide (systemic) stress scenario with more specific macroeconomic indicators thereby allowing it to estimate and model the likely impacts upon its income statement, balance sheet, Tier 1 risk-based capital, regulatory Tier 1 common equity, economic capital, and material lines of business.

Banks should identify, assess and regularly update the scenarios most likely to cause their business model to become non-viable or to fail.

The recovery plans of banks should take into account of the specific circumstances of its standing in the market, and reflect the nature, complexity, interconnectedness, level of substitutability and size of the bank. As a result, different banks will have differing ranges of possible recovery actions/ options depending upon their size, structure and activities. The options available to small banks are likely to be fewer and therefore their plans will be simpler as compared to large banks. Banks should include a range of credible options to be flexible enough to be effective in a variety of idiosyncratic and market-wide stress circumstances.

The banks could, therefore, consider the following possible recovery measures while preparing their recovery plans. Banks should identify the necessary steps in detail and the time needed to implement such measures and assess the associated risks. The banks

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<sup>1</sup>The FSB has, in July 2013, published three guidance documents relating to Recovery and Resolution Planning for Systemically Important Financial Institutions focusing on regulators, supervisors and resolution authorities and especially those that participate in CMGs for future strategies in recovery and resolution planning. These documents are titled “Guidance on Developing Effective Resolution Strategies”, “Guidance on Identification of Critical Functions and Critical Shared Services” and “Guidance on Recovery Triggers and Stress Scenarios”. The guidance paper draws on the work undertaken by the CMGs in preparation of recovery and resolution plans of the G-SIBs.

G-SIFIs typically use two to four stress scenarios for recovery planning purposes. They employ both systemic and idiosyncratic stress scenarios, and in many case a combination of the two scenarios. The number of scenarios generally depends on the individual G-SIFI and the guidance of the relevant supervisory authority. The scenarios range in severity and typically include a number of components, such as, significant capital and liquidity impacts, severe losses through a rogue trader, rating downgrades, a Euro or US dollar crisis, GDP growth rates, loss of goodwill, exodus of talent, significant deposit withdrawal or runoff, collapse of global financial markets, currency rates, commodity prices, bank failures, fraud, reputational crises, etc.

should, however, ensure that the recovery options do not in any way interfere with their operational stability.

The dependencies between the various options also need to be examined and structured into the Recovery Plan. The banks should assess the additional requirements to which they may potentially become subject during crisis situations in order to maintain their membership of Financial Market Infrastructures (FMIs), for example, as regards pre-funding or collateralising of positions, and identify options for addressing the additional requirements (for example, plan for the sourcing of additional collateral, and assess potential constraints on the bank's total payment flows). Banks should also have in place appropriate contingency arrangements (for example, functioning of internal processes, IT systems, clearing and settlement facilities, supplier and employee contracts) that enable them to continue to operate as they implement recovery measures. The range of possible recovery measures could include:

- Actions to strengthen the capital situation, for example, recapitalisations after extraordinary losses, capital conservation measures such as suspension of dividends and payments of variable remuneration;
- Possible sale of subsidiaries and spin-off business units;
- A possible voluntary restructuring of liabilities through debt-to-equity conversion; and
- Measures to secure sufficient funding while ensuring sufficient diversification of funding sources and adequate availability of collateral in terms of volume, location and quality. Proper consideration should also be given to possible transfers of liquidity and assets within the group.

**(i) Capital, Liquidity and Profitability**

The recovery plans should invariably consider options that address capital shortfalls and liquidity pressures. Banks may, therefore, lay stress on documenting such options that focuses on sustaining and restoring their capital and liquidity resources and ultimately their profitability under a range of stress scenarios.

The plan should ensure that the recovery options do not just solve the short-term capital or liquidity shortfalls but should focus on the bank's long-term viability once the particular stress scenario occurs. The ultimate objective should be to examine the effects on its profitability.

The banks are already required to make capital planning in lieu of its possible kinds of exposed risks as a part of its ICAAP document. The recovery plan should consider the possibility that the planned capital buffer in the ICAAP may turn out to be inadequate to absorb losses during a crisis.

Banks are required to prepare a contingency funding plan (CFP), as a part of its normal liquidity risk management, for addressing severe disruptions in liquidity which might affect the bank's ability to fund some or all of its activities in a timely manner and at a reasonable cost. The recovery plan should, however, consider liquidity options that are over and above the requirements provided for in the CFP for facing the liquidity crisis that could be more severe than those projected in its liquidity stress tests.

The recovery options should clearly mention the details of available/ potential contingency funding sources and the estimated amount which can be drawn from these sources, clear escalation/ prioritisation procedures detailing when and how each of the actions could be activated and effected and the lead time needed to tap additional funds from each of the contingency sources. Banks could also enter into agreements with different banks/ financial institutions or private markets for contingency funding lines and / or reciprocal lines of credit which are more than estimated under the contingency finding plans.

It is also very important that banks also take into account the potential simultaneous effect of capital restoration recovery options on deterioration of the liquidity resources.

## **(ii) Radical options**

With a view to preparing a robust recovery plan, especially in case of large banks, it is necessary that banks consider certain extreme radical options *such as, restructuring of their business structure by either restructuring their liabilities portfolio (by debt-to-equity conversion or write-off) or selling a part or whole of their business line or even selling the entire bank to a private third party*, as a part of their recovery plan. Though it is difficult to assess the value of such extreme options in advance without the severe event actually happening, banks should focus on such aspects in a broader way. The recovery plans with such options would also help the regulators/ supervisors and the resolution authorities in assessing the bank's resolvability.

### **(iii) Central Bank facilities**

While assessing the effects of the liquidity stress scenarios, the banks should also address, as a part of its recovery plan, when and how to contact external parties, such as regulators/ supervisors, central banks or payment system operators. The recovery plan should include an analysis of the bank's plan to apply for the use of central bank facilities in stressed conditions. The Reserve Bank's Liquidity Adjustment Facility (LAF) provides liquidity insurance to eligible banks to help them tide over short-term liquidity mismatches or shocks. In terms of Section 17 of the Reserve Bank of India Act, 1934, the Reserve Bank acts as a "lender of last resort" and also provides loans to eligible banks against eligible collateral in times of extreme stress situations.

The banks should, while preparing the recovery plan, should consider the appropriate amount of assets that could be collateralised in order to facilitate easy access of the central bank's facilities. They should in effect analyse the types of assets that could be collateralised, as also estimate their drawing capacity taking into account the applicable haircuts on the market value of assets. The recovery plan should also indicate the types of circumstances in which such a central bank facility would be invoked. However, such assessments of central bank facility should be realistic.

### **Trigger framework for implementation of recovery plan**

One of the essential elements of recovery plans is that they should define clear backstops and escalation procedures, identifying the criteria (both quantitative and qualitative) that would trigger the implementation of the recovery plan (or individual measures in the plan) by the management of the banking group or in consultation with the regulatory/supervisory authorities. Such triggers should be designed to prevent undue delays in the implementation of recovery measures.

A key component of the RRP framework is to decide on when the particular bank will implement aspects of its recovery plan and when the resolution authority/ regulators/ supervisors would implement the resolution plan for orderly resolution of the bank without affecting the financial stability. It is, therefore, necessary that banks develop their own triggers, the breach of which would require implementation of the recovery plan.

#### *Linkage with existing prudential triggers for initiating regulatory/ supervisory action*

The Reserve Bank has, as a part of the regulatory/ supervisory intervention framework, developed a framework for "Prompt Corrective Action (PCA)". The PCA framework links the

regulatory action to quantitative measures of performance, compliance and solvency, such as CRAR, NPA levels and profitability. Under the PCA framework, regulatory/ supervisory actions (certain structured and discretionary actions) could be initiated based on identified trigger points including serious deterioration in CRAR, Net NPA and Return on Assets (RoA) beyond the tolerable limits. Such actions could result in placement of banks under supervisory regime for closer monitoring and handholding. The objective of the PCA framework has been to take timely corrective action when the bank still has adequate cushion of capital so as to minimize the cost to the insurance fund/ public exchequer in the event of a forced liquidation of the bank. As such, the discretionary actions taken under the PCA framework are taken not as a part of resolution regime but to put the bank's operation in order. The corrective actions have been structured in various stages depending upon the deterioration in the three parameters. While the supervisory action generally includes measures for recovery of the bank to viable position, it also includes actions leading to initiation of resolution proceedings.

The aim of triggers in recovery planning is to enable banks to restore financial strength and viability through their own efforts, i.e. before the conditions are met for regulatory authorities to enforce recovery measures. The banks should, therefore, calibrate their triggers for initiation of recovery measures in a manner that negates the initiation of regulatory/ supervisory intervention measures. This means that such trigger mechanism should be early enough to give the bank time for the recovery plan to have an effect.

### *Early Warning Signals*

In addition to the recovery triggers that will require the bank to initiate recovery actions on breach of the triggers, banks could develop certain early warning signals or indicators, which could signal the developing problems at the very incipient stage for early action even before the breach of recovery plan triggers. These early warning signals could serve as the starting point for discussions within the bank to allow it to take pre-emptive actions against the stress. This could also serve as the starting point for reviewing the recovery plan triggers. The early warning signals prior to an actual breach of a trigger also may be useful for alerting the bank management to emerging signs of distress.

Some examples of possible early warning signals (these are not exhaustive) are as follows:

- an expectation of a drop in bank's credit rating;
- utilisation of bank's capital planning buffer;
- negative market sentiment or perception towards the bank, possibly measured by liquid market-based indicators, such as unexpected fall in share price relative to peers,

etc.

- the invocation of the bank's contingency funding plan has been triggered.

This has been one of the areas where there is a growing consensus among most of the advanced jurisdictions, so that the banks are able to act well in advance. The G-SIFIs generally view triggers as a pre-determined point in time at which the firm will notify senior management and its board, and its supervisory authority. They also use early warning indicators to signal negative trends and initiate action prior to a potential breach of an identified trigger point<sup>1</sup>.

#### *Characteristics of recovery plan trigger framework*

The recovery plan trigger framework should be based on the following elements:

- (i) Banks should use both quantitative<sup>2</sup> and qualitative triggers to initiate recovery actions.
- (ii) It should be clear when the triggers have been breached.
- (iii) The triggers should be well-defined and the required recovery actions in case of breach of triggers should be very clear.
- (iv) The triggers should be effective for a range of stressed situations, including bank-specific (idiosyncratic), market-wide (systemic), as well as a combination of both.
- (v) The triggers should contain forward-looking elements (and not linked to inherently lagging metrics) to ensure that there is no time-lag before the triggers indicate severe stress in a bank.
- (vi) The triggers should be calibrated in a manner so that they provide sufficiently early warning to allow the bank to take corrective actions and for the resolution authority to begin contingency planning. Banks should provide regulators/supervisors and resolution authorities with an explanation of how the trigger calibrations were determined, as well as an analysis that demonstrates that the triggers would be breached early enough to be effective.
- (vii) There should be a proper reporting mechanism relating to breach of triggers. Any breach of triggers should automatically cause a predetermined escalation and information process up to the senior management level within the bank.

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<sup>1</sup>Some G-SIFIs do not identify triggers for the specific purpose of recovery planning, but rather use only triggers existing in the institution's current risk management framework, or early warning indicators, which are part of the institution's internal risk management processes.

<sup>2</sup>G-SIFIs use both quantitative and qualitative triggers in their recovery plans. The number of triggers generally range between three and seven, which varies from institution to institution. The triggers are predominantly quantitative and are focused on institution-specific liquidity and capital measures.



- (viii) Information about the escalation process to senior management or board of directors when triggers are breached, as well as information about the decision making process by the senior management and the board, should be informed to the regulators/ supervisors and resolution authorities.
- (ix) There should be a proper communication system with the regulatory/supervisory authorities (and resolution authorities where appropriate) in case of bank's experience with high levels of stress or breach of recovery plan triggers.

The quantitative triggers often focus on the extent of speed of change in different elements, such as:

- ratings downgrades;
- revenue reports or P & L (or components of these);
- credit risk limits;
- equity ratios;
- per cent renewal of wholesale financing;
- withdrawal of deposits and other funding;
- increased collateral requirements;
- rise in public debt;
- GDP forecasts;
- Senior debt spreads, etc.

Qualitative triggers are also an important component, though the use of such triggers in recovery plans is currently much less widespread than quantitative triggers. An example of a qualitative trigger is one based on counterparty risk, where different indicators are monitored to signal a potential counterparty risk event. The indicators could include, in respect of the bank: requests from counterparties for early redemption of liabilities, difficulties in issuing liabilities at current market rates, an unexpected loss of senior management, and adverse court rulings.

### Key components of Recovery Plan

This Annex provides the detail of information that is required to be submitted by the banks while submitting the Recovery Plan. This contains two Sections, i.e. Overview and Recovery Plan. The first Section gives the summary of the Board of Director's oversight over the preparation of the Recovery Plan, as well as the summary of the stress scenarios and the recovery actions the banks have identified to restore its financial strength and viability should a stress event occur. The second Section details about the requirement of furnishing information regarding the bank's complete menu of credible options for addressing a range of stress scenarios caused by bank-specific (idiosyncratic), market-wide (systemic) or a combination of both.

Though this guidance relates to large banks with complex business models, the smaller banks are expected to submit the information on best effort basis as much of the information may not be applicable to them.

#### Section 1: Overview

This section would indicate to the regulators/supervisors and the resolution authorities regarding the process and procedures followed in preparation of the recovery plan. It also provides assurance to the authorities that the Board of Directors and senior management of the bank understand and support the information contained and furnished as a part of the recovery plan. The key elements of this Section are as under:

- Confirmation that the Board of Directors and the senior management has approved and reviewed the recovery plan, and that the bank has established appropriate governance framework for the recovery and resolution plan;
- Views of the bank of its ability to recover from a severe stress event;
- Summary of the issues and recovery actions that the bank has identified in consultation with the regulatory/ supervisory authorities;
- Description of any material changes in the recovery plan since the last submission.

## Section 1: Overview

S. No.	Subject matter	Required information/ data
1.1	Approval and quality control	Confirmation that the Board of Directors has approved and reviewed the recovery plan.
		Confirmation that the Board has understood the process adopted for preparation of the recovery plan, and that it is sound and robust.
		Nomination of the chairman of the Risk Management Committee of the bank, who will be responsible for the bank's recovery plan, for acting as the bank's nodal contact point with the regulatory authorities.
1.2	Bank's views on ability to recover	A brief on bank's views on the credibility of the recovery options contained in its recovery plan and the extent of the executability of the actions in a severe stress event. The brief should also explain why the bank considers that the range of recovery options is adequate enough to restore its financial strength and viability should the stress event happens.
1.3	Summary of recovery actions	A summary of the issues and recovery actions the bank has identified that it will take in the severe stress situations.
1.4	Description of material changes	A summary of the issues and the recovery actions that the bank has added/ deleted to the existing recovery plan.

## Section 2: Recovery Plan

The recovery plan is a plan prepared and maintained by the bank that identifies a complete menu of credible options, to restore financial strength and viability, for addressing a range of financial stresses caused by the bank-specific, market-wide stress or a combination of both. The recovery plan should include all credible options for addressing both capital and liquidity problems.

The key elements of the recovery plan are as under:

- Brief note on existing risk management framework put in place by the bank and integration of the recovery plan with the risk management framework and/ or crisis management framework.
- Detailed note with explanation on identification of quantitative and qualitative triggers that would prompt the bank to initiate suitable recovery actions, the calibration process with the kinds of stress scenarios adopted, and the process involved in communicating the event of breach of trigger to the senior management/ board/ regulators/ supervisors as well as ways to recover from that event.
- A brief summary of bank's complete menu of credible recovery options to give an overall view of the potential possibilities.
- Detailed description of each recovery option and potential range of impact of each option on bank's capital/ liquidity/ balance sheet, on-going business operations, its rating, etc., as well as the probability of success of such options.
- A plan for accessing central bank liquidity facilities.
- A plan of taking radical actions such as, selling off a part or whole of a particular business line, option of selling the entire bank to a private third party, etc.
- A list of key officials (preferably at a higher level) who will be involved in initiating/ implementing the recovery actions, along with their roles and responsibilities, as also the list of the supporting staff who would be supporting the implementation plan.

## Section 2: Recovery Plan

S. No.	Subject matter	Required information/ data
2.1	<b>Recovery Plan Overview</b>	Bank should give detailed process and procedure of the steps followed in preparation of the recovery plan and taking approval of the Board, the oversight of the Board and the governance framework.
2.1.1	<b>Integration of recovery plan with risk management framework</b>	Bank should prepare a brief note on existing risk management framework in place. The note should also detail how the recovery plan has been integrated with the existing risk management framework and/ or crisis management framework.
2.1.2	<b>Stress scenarios</b>	Details about the components/ elements of stress testing. Also describe the stress scenarios, explaining the assumptions in severity.
2.2	<b>Trigger framework for implementation of recovery plan</b>	A key component of a recovery plan is to identify the criteria that would trigger the implementation of the recovery plan by the bank's management or in consultation with the regulatory/supervisory authorities. The triggers could comprise quantitative or qualitative or a combination of both. The triggers need to be designed in a manner so as to prevent undue delays in timely kicking off the implementation process of recovery actions.
2.2.1	<b>Identification process</b>	Bank should indicate the process and procedure followed in identification of both quantitative and qualitative triggers. It should also detail the procedure of breach of identified triggers and the actions needed to be taken.
		Has the bank identified early warning indicators for alerting the management of emerging signs of weakness. If Yes, describe the process and methodology followed to identify the early warning indicators. The early warning indicators could serve as a starting point for monitoring the recovery triggers as well as taking pre-emptive actions well in advance before reaching the stage of breach of recovery triggers.
		Define the triggers that should contain a combination of qualitative and quantitative indicators/criteria. The quantitative triggers should contain forward-looking elements to ensure that there is no time-lag before the triggers indicate severe stress in an institution. The bank should also be prepared to activate its Recovery Plan if it has determined that its viability is at risk, even though none of the triggers have been met.

<b>2.2.2</b>	<b>Details about early warning indicators and recovery triggers</b>	Bank should separately give details of the identified early warning indicators and recovery triggers (both quantitative and qualitative triggers) with threshold levels that will trigger the recovery actions.
		Describe the threshold levels at which the recovery actions would be triggered taking into account various stress scenarios. The particular actions that needs to be taken on breach of a particular trigger should also be clearly indicated.
		The communication strategy followed by the bank on breach of triggers should be clearly indicated.
<b>2.3</b>	<b>Recovery plan options</b>	
<b>2.3.1</b>	<b>Summary of complete menu of recovery options</b>	A substantive summary of complete menu of credible options and the steps required to effect it, may be given.
<b>2.4</b>	<b>Detail of each recovery option</b>	Description of each recovery option may be given in detail.
<b>2.4.1</b>	<b>Impact of each recovery option</b>	A description on impact of implementing each recovery option may be given.
		Potential impact of each option on capital, liquidity and balance sheet.
		Impact of each option on the on-going business operations and support functions.
		Impact of each option on bank's reputation.
		Impact of each option on bank's rating.
<b>2.4.2</b>	<b>Possible issues in execution</b>	Impact of each option on the wider domestic financial system.
		Detailed framework describing the execution and implementation of each recovery option.
		Dependencies and assumptions made in each case of recovery option.
		Obstacles and hurdles in successful implementation of recovery option.
		Any regulatory and legal issues that could arise in successful implementation of the recovery option and ways to overcome.
<b>2.4.3</b>	<b>Credibility of recovery options</b>	Estimated time to realise the benefits of the recovery option.
		An assessment of credibility of each recovery option.
		Effectiveness of recovery option against the possible severe stress scenarios, both bank-specific (idiosyncratic) and market-wide (systemic stress). Details could also be given if in case of certain stress scenarios, a combination of recovery options could be used. An assessment of the situations in which a particular recovery option may not be feasible to implement.
		Assessment of potential factors and material impediments that could reduce the likelihood of

		successful and timely implementation of the recovery option and how these could be mitigated.
		Bank's perception of the circumstances that would render the recovery options unavailable.
<b>2.5</b>	<b>Plans for accessing central bank liquidity facilities</b>	Banks should prepare plans for accessing the Reserve Bank of India's liquidity facilities and overseas central bank liquidity facilities.
		The plans should indicate the nature of those facilities.
		Circumstances in which banks would access the central bank liquidity facilities.
		Conduct an assessment of the eligible assets and drawing capacity against these. Also assess the same in stress scenarios.
		Documentation on the process and procedure for accessing central bank liquidity facilities.
		Analyse the methods that would be adopted for repayment of the liquidity facilities availed from the central bank.
<b>2.6</b>	<b>Radical options</b>	A plan of taking all possible radical actions such as, selling off a part or whole of a particular business line, option of selling the entire bank to a private third party, etc. in the extreme stress events.
		The plan should bring out in detail the execution plan for all radical options, when found necessary to implement. This should form a part of the recovery plan. It is understood that requirement to implement such radical options would mean that the bank has more or less become non-viable.
		For each radical option, give outline of the potential strategic investor or purchaser.
		Analysis of any obstacle or barriers that could restrict the implementation of any particular radical option.
		Indicate the time required to effect such option.
		Explain in detail what due diligence information would be required in advance for effecting such radical options.
		Describe any legal hurdles, such as competition issues, etc. in implementing the radical options.
<b>2.7</b>	<b>List of key executives/ officials involved in the process</b>	A list of key officials (preferably at a higher level) who will be involved in initiating/ implementing the recovery actions, as also the list of the supporting staff who would be supporting the implementation plan.
		Roles and responsibilities of these key officials for executing preparatory and recovery actions.

## Data Template for Domestic Systemically Important Banks

I. General Information		
1	Name of the bank	
2	Information as on	
3	Date of reporting	
4	Reporting currency	

### II. Organizational/Financial Group Structure and Key Legal Entity Information

#### 1. Organizational/Financial Group Structure

##### 1.1 Furnish a diagram as well as detailed description of the bank's organizational structure and their arrangement in hierarchical order

- (i) Description of Organizational structure should include:
- (a) Total Number of material legal entities in the organization/group
  - (b) Names of all material legal entities (including all legal entities with banking license issued by RBI) within the bank's organization
  - (c) Names of locations, jurisdiction of incorporation, licensing, and key management associated with each material legal entity and foreign office identified
  - (d) Mention in brief the relative size of each of the legal entities by indicating the total assets and total business made.
  - (e) Name the parent of each of the legal entity with the percentage of voting and non-voting rights/equity shareholding the parent and the other legal entities within the organization/group holds.
  - (f) Describe the business model/operations as also the business lines of each of the legal entities of the organization/group.

##### 1.2 Branches and Subsidiaries of legal entities

- (i) Furnish a list of branches and subsidiaries separately for each of the legal entities of the organization/group with location and geography, other than India.
- (ii) Give details of the business done in each of the branch and subsidiary separately with a summary on P & L Statement and balance sheet.

##### 1.3 Support Functions

- (i) Give details of the support functions provided by the legal entities within the organization/group. The support functions include IT services, accounting and tax, internal audit and compliance, data storage and maintenance, and other support functions. The information should also include the name of the legal entity



providing a particular support function and to which legal entities, along with the procedure of providing the support.

## **2. Capital Structure and Shareholding Pattern**

### **2.1 Capital Structure**

- (i) Give information on minimum regulatory capital requirements specified by the sectoral regulator/host regulator for each of the material legal entity of the organization/group
- (ii) Furnish details of authorized capital, paid-up capital, and capital structure split into components of CET1, Tier 1, Tier 2, etc., including the analysis, for each of material legal entity of organization/group.
- (iii) Give details of sources of capital raised/to be raised by each legal entity, including details of sources outside the organization/group.
- (iv) Amount of surplus capital maintained vis-à-vis current regulatory requirements/prescriptions, by each legal entity and in aggregate.
- (v) Give information on each of outstanding debt securities by class (senior unsecured, lower Tier 1 subordinated debt, etc.) and type (medium term notes, commercial paper, certificate of deposits, etc.).
  - (a) the governing law for the contractual terms of the debt outstanding;
  - (b) location of the debt;
  - (c) terms and conditions of the concerned debt securities;
  - (d) whether any guarantee exists for such debt outstanding;
  - (e) names of the persons/companies/institutions/trusts/etc. contributing to the debt of the particular legal entity, along with information on total amount, maturing date, etc.

### **2.1 Shareholding Pattern**

- (i) Give names of major equity shareholders in each legal entity of organization/group along with details of total number of equity shares, number of equity shares held by major shareholders (5% or more equity holding), percentage shareholding by major shareholders.
- (ii) Information on amount of capital allocated by parent entity to each entity along with method of provision of capital to each entity.
- (iii) Details of payment of dividend, coupon, maturity cash flows, etc. by the legal entities to the parent entity.
- (iv) Information on restrictions, if any, on transfers of capital to other legal entities within the group.

## **3. Funding of entities**

- 3.1 Give details of sources of funding for each of the legal entity. The information must include the names and amounts of funds provided:
  - (i) details of deposits;
  - (ii) certificate of deposits;
  - (iii) debt securities as part of capital;
  - (iv) off-balance sheet funding;
  - (v) access to central bank funding, split into normal and special operations, where applicable.
  - (vi) other sources including short-term financing, repos, etc.

- 3.2 **Give overview of funding relationships within the group. The information should include:**

- (i) Current intra-group balances;
- (ii) Current intra-group guarantees. This information should detail the following:
  - (a) total exposures under intra-group guarantees, including types of guarantees extended and to which entity;
  - (b) when can the guarantees be enforced;

### **3.3 Other financial dependencies**

- (i) Furnish details of all other intra-group financial dependencies.

## **III. Financial interconnectedness**

### **1. Intra-financial system assets**

#### **1.1 Lending/deposits to/in financial institutions**

- (i) Amount lent to other financial institutions, including break-up of names and amounts lent to each of the financial institution;
- (ii) Amount deposited with other financial institutions, including break-up of names and amounts deposited in each of the financial institution;
- (iii) Undrawn committed lines extended to other financial institutions.

#### **1.2 Investments in securities issued by other financial institutions**

- (i) Information should include names and amount of investments made by the bank in each of the financial institutions:
  - (a) Secured debt securities;
  - (b) Senior unsecured debt securities;
  - (c) Subordinated debt securities;
  - (d) Commercial paper;
  - (e) Certificate of deposits;
  - (f) Equity including ordinary and preferred shares.

#### **1.3 Securities financing transactions with other financial institutions (part of Collateralised Borrowing and Lending Obligations)**

- (i) Names and amount of net positive current exposure of securities financing transactions with each of the other financial institutions.

#### **1.4 OTC derivatives with other financial institutions**

- (i) Net positive fair value
- (ii) Potential future exposure using current exposure method
- (iii) Fair value of collateral that is held for these derivatives

#### **1.5 Total intra-financial system assets**

### **2. Inter-financial system liabilities**

#### **2.1 Deposits from other financial institutions**

- (i) Information should include break-up of names and amount of deposits received from each of the financial institutions:
  - (a) all funds deposited by other banks;
  - (b) all funds deposited by non-bank financial institutions;
  - (c) undrawn committed lines obtained from other financial institutions.

#### **2.2 Loans/borrowings from other financial institutions**

- (i) Information should include break-up of names and amount of loans/borrowings received from each of the financial institutions:
  - (a) loans/borrowings received from other banks;
  - (b) loans/borrowings from non-bank financial institutions;
  - (c) undrawn committed lines of loans/borrowings from other financial institutions.

### **2.3 Marketable securities issued by the bank**

- (i) Information should include break-up of names and amount of securities issued to which financial institutions:
  - (a) secured debt securities with one year or less remaining to maturity;
  - (b) senior unsecured debt securities with one year or less remaining to maturity;
  - (c) Subordinated debt securities with one year or less remaining to maturity;
  - (d) Commercial paper with one year or less remaining to maturity;
  - (e) Certificates of deposit with one year or less remaining to maturity.

### **2.4 Securities financing transactions with other financial institutions (part of CBLOs)**

- (i) Names and amount of net negative current exposure of securities financing transactions with each of the other financial institutions.

### **2.5 OTC derivatives with other financial institutions**

- (i) Net negative fair value;
- (ii) Potential future exposure using current exposure method;
- (iii) Fair value of collateral provided in respect of these derivative contracts.

### **2.6 Total intra-financial system liabilities**

## **3. Critical Functions in each legal entity**

Critical functions (as defined by FSB in its consultative document on Recovery and Resolution Planning – Making the key attributes requirements operational) are activities performed for third parties, where failure would lead to disruption of services vital for the functioning of the real economy and for financial stability due to the banking group's size or market share, external and internal interconnectedness, complexity or cross-border activities. E.g. payments, custody, particular lending and deposit activities in commercial or retail sector, clearing and settling, limited segments of wholesale markets, market making in certain securities and highly concentrated specialty lending sectors.

### **3.1 Deposit taking services (other than financial intermediaries)**

- (i) Total number and total amount of savings accounts
  - (a) Retail savings accounts
    - Of which, insured by DICGC
  - (b) Corporate savings accounts
    - Of which, insured by DICGC
- (ii) Total number and total amount of fixed deposit accounts, with different maturity buckets
  - (a) Retail fixed deposit accounts
    - Of which, insured by DICGC
  - (b) Corporate fixed deposit accounts
    - Of which, insured by DICGC
- (iii) Total number and total amount of current accounts
  - (a) Retail current accounts;
  - (b) Corporate current accounts

### **3.2 Lending/credit services (other than financial intermediaries)**

- (i) Total number and total amount of loans (outstanding) provided
  - (a) Retail customers - with bifurcation on short-term and long-term

- lending
  - Of which, secured loans by type of securities collaterals (such as mortgage, equipment, auto, etc.)
  - Number and amount of approved but undrawn loans under each of category
  - Of which, unsecured loans
- (b) Retail lending made available through credit card products
  - Total outstanding amount
  - Total undrawn lines
  - Total number of cards issued and of which, how many are active
  - Number of customers that have two credit cards
  - Number of credit cards not paid within a month
- (c) Corporate lending - with bifurcation on short-term and long-term lending
  - Of which, secured loans with details of nature of loans
  - Of which, unsecured loans with details of nature of loans
- (d) Trade finance
  - Total outstanding amount
  - Total undrawn lines

### **3.3 Capital market exposures/activities**

- (i) Long term investments in capital (on its own account) of:
  - (a) Other financial institutions - details of name and amount of each investee financial institution
  - (b) Companies/corporates/venture capital - details of name and amount of each investee companies
  - (c) Government securities - details of amount and maturity of investments in State Government and Central Government securities
  - (d) Commodities market
- (ii) Investments in capital (on behalf of clients) of:
  - (a) Other financial institutions
  - (b) Companies/corporates/venture capital
  - (c) Government securities
- (iii) Advisory services on trading of securities
  - (a) Details of advisory services provided to companies/corporates relating to mergers and acquisitions, debt structure, etc.
- (iv) Is the bank taking part as primary dealer (departmentally or as a subsidiary) in making of government securities market
  - (a) Transaction volume and value for each of type of securities acquired along with the maturity

### **3.4 Payment and settlement services**

- (i) Services as a settlement bank in cheque clearing
  - (a) Details on transaction volume and value for each location of clearing house managed by the bank
  - (b) Details of number of members banks of each clearing house managed by the bank
  - (c) Details of payment and settlement services provided to non-member banks (sub-members) for each location of clearing house managed by the bank
  - (d) Details of name of non-member banks for which the bank is providing settlement services in any of the cheque clearing houses (not managed by the bank)
- (ii) Services for electronic payment and settlement

- (a) Details on number of locations where the bank is managing the electronic payment services
- (b) Location-wise transaction volumes and value separately for ECS - Debit and Credit clearing
- (iii) Transaction volume and value in handling fund transfer requests from customers under RTGS
- (iv) Credit card merchant services
  - (a) Transaction volume and value of intermediary payment and settlement services provided by the bank between merchants and service providers and credit card networks
- (v) Exchange services
  - (a) Details on access provided to customers to stock exchanges as a system member
  - (b) Transaction volume and value of such access provided
- (vi) Membership of securities settlement system
  - (a) Is the bank maintaining a SGL account
  - (b) Names and details of the institutions for which the bank maintains CSGL account

### **3.5 Cash services**

- (i) Size of retail branch network and ATM network
  - (a) State-wise details of number of branches of the bank
  - (b) State-wise details of number of ATMs installed by the bank
  - (c) Details of ATM service provided to other banks
- (ii) Details of currency chests managed by the bank
  - (a) Number of currency chests managed by the bank, with geographical locations
  - (b) Number of banks attached to each of the currency chests managed by the bank
  - (c) Transaction volume and value of cash deposits and withdrawals in each of the currency chest

### **3.6 Critical shared services**

Critical shared services are activities performed within the bank, or outsourced to third parties, where failure would lead to the inability to perform critical functions, and therefore to disruption of services vital for the functioning of the real economy or for financial stability. Examples include information technology provisioning given the dependency of core banking services on IT and other services such as, facility management and/or administrative services.

- (i) Third party services
  - (a) Services provided by the bank to other financial institutions, such as credit card systems, cheque processing, etc.
    - Names of financial institutions with details of services provided
  - (b) Details of IT services provided by the bank to other financial institutions
    - Data storage and processing
- (ii) Functions outsourced by the bank
  - (a) Details of financial services outsourced
    - Names of the service provider with details of service level agreements
  - (b) Details of IT services outsourced
    - Names of the service provider with details of service level

agreements

Data storage and processing

Other IT infrastructure, workstations, telecoms, servers, data centres and related services

Software licences and application software source code base

Access to external providers

Application maintenance (software application maintenance and related data flows)

Report generation

Disaster recovery solutions

(c) Transaction processing outsourced

Names of the service provider with details of service level agreements

(d) Legal services/compliance

Details of corporate legal support

Details of business/transactional legal services

Details of compliance support