Syllabus subtopic:

- Indian Economy and issues relating to Planning, Mobilization of Resources, Growth, Development and Employment
- Government Policies and Interventions for Development in various sectors and Issues arising out of their Design and Implementation.

Prelims and Mains focus: About the proposed law and key changes to be brought by it; its advantages; about FRDI Bill; NBFCs

News: The Finance Ministry is working on putting in place a comprehensive resolution framework for financial institutions that have precarious financial position.

What is it for?

It is to ensure that failure of some of the systemically important financial institutions does not affect the entire system.

Background

- In the recent period, the failure of some large non-banking financial companies (NBFCs), along with co-operative banks, have created panic among depositors as well as the financial sector as a whole.

- In September 2019, the RBI had put Punjab and Maharashtra Co-operative Bank under “directions” due to weak financial health over its exposure to near-bankrupt realty player HDIL, to which it has loaned over 70 per cent of its Rs 9,000 crore in advances. While the central bank slapped restrictions on the bank for six months on September 24, it allowed withdrawal of only Rs 1,000, creating panic among the depositors.

- On September 26, following a spate of complaints from the depositors, the RBI relaxed the curbs and capped withdrawal at Rs 10,000 and then, on October 3, the cash withdrawal limit was raised to Rs 25,000. It was subsequently raised to Rs 40,000 and then to Rs 50,000 over the next one
month.

- In November 2019, the government amended the Insolvency and Bankruptcy Code (IBC) rules to provide for a resolution of financial service providers (FSP) including NBFCs. This provided a generic framework for insolvency and liquidation proceedings of systemically important FSPs other than banks. Following this, the Reserve Bank of India (RBI) moved for resolution of DHFL.

- However, government sources said these changes do not address the issue comprehensively and were aimed at immediate resolution of NBFCs.

About the proposed framework

- The mechanism proposed by the Ministry — which is likely to be brought in through a new law — envisages setting up of a Resolution Authority comprising members from financial sector regulators as well as senior government officials as its members.

- The government has held series of discussions — including during meetings of the Financial Stability and Development Council — to put in place a framework in this regard.

Ambit of resolution authority

- The ambit of the Resolution Authority is likely to be over banks, NBFCs, insurance companies, securities market players, co-operative banks and regional rural banks.

- In the recent period, the failure of some large non-banking financial companies (NBFCs), along with co-operative banks, have created panic among depositors as well as the financial sector as a whole. The central government is also working on increasing the deposit insurance limit of Rs 1 lakh at present to Rs 5 lakh.
Changes likely to be in FRDI Bill

- The central government is also working on increasing the deposit insurance limit of Rs 1 lakh at present to Rs 5 lakh.

- The Finance Ministry had, in 2018, withdrawn the proposed Financial Resolution and Deposit Insurance (FRDI) Bill over the controversial bail-in clause, which led to fears that the government may cancel or modify deposits in banks.

- The new resolution framework being piloted by the Department of Economic Affairs could tone down some of the bail-in provisions, providing protection to deposit holders.

- On the lines of the FRDI Bill, the proposed framework aims to address the issue of insolvency of firms in the financial sector — so that if a bank, NBFC, insurance company, pension fund or mutual fund run by an asset management company, fails, a solution is available to either sell that firm, merge it with another firm, or close it down, with the least disruption to the system, to the economy, and to investors and other stakeholders.

- This would require change in existing laws so that some of the powers of financial sector regulators are transferred to the Resolution Authority being proposed in the new regime.

- The Bill is expected to come in the Parliament after it is cleared by the Union Cabinet. Department of Economic Affairs has been piloting it and is expected to be ready with it. The bail-in provision was controversial and the government would truncate the issue and bring it. So, the government would be coming up with the revised version of the bill.

Way forward

A framework for resolution is required even for banks, insurance companies, mutual funds, securities market companies, so that their failure does not affect the
financial system adversely. The proposed law is aimed at addressing this issue at the broader level.