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# Bank crisis management and resolution after SVB and Credit Suisse: Perspectives from India and the European Union

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## Abstract

The March 2023 bank failures of Silicon Valley Bank, Signature, and Credit Suisse, which caused turmoil in financial markets and led to regulatory and central bank intervention, revived the debate about the effectiveness of the bank crisis management, resolution, and deposit insurance legal framework established after the Global Financial Crisis. Although the March 2023 events did not escalate into a full-blown financial crisis, they drew attention to certain areas of the current framework, where improvements may be needed. These areas include the need for financial regulation and supervision to focus more on small- and medium-sized banks as potential sources of systemic market events; to review the adequacy of the current deposit insurance regime and the treatment of uninsured deposits; and to provide more clarity about the order of creditor claims in case of bank resolution/insolvency. This article reviews the events of March 2023 and the key lessons from these events and discusses how these lessons could shape the frameworks for bank crisis management and resolution in India and the European Union. The two jurisdictions are in the process of updating their laws in this area, and the March 2023 events could influence the relevant decisions.

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## 1 | INTRODUCTION

The international framework for crisis management and resolution of banks and the deposit insurance schemes, which were reformed after the Global Financial Crisis (GFC), received increased attention during the financial market turmoil of March 2023. The turmoil started on 10 March 2023, when Silicon Valley Bank (SVB), a medium-sized US bank with significant presence in technology markets, was declared insolvent by California regulators.<sup>1</sup> The bank had experienced significant deposit outflows following a deterioration of its financial situation, partly driven by the Federal Reserve's interest rate rises during the preceding period and mismanagement of its risks. SVB had also experienced significant decline in its stock price.<sup>2</sup>

The run on SVB was driven not by retail depositors, whose deposits were insured and, therefore, protected, but by uninsured depositors comprising mainly companies, which feared that they would be unable to access their deposits.<sup>3</sup> Uninsured depositors were holding a high percentage of the bank's deposits.<sup>4</sup> SVB's failure was followed on 12 March 2023 by that of Signature Bank, a second medium-size US bank, which had also experienced significant deposit outflows driven by uninsured depositors and decline in its stock price.<sup>5</sup> The two bank closures generated market fears for similar moves in other US banks and resulted in a decline in bank share prices on the stock market. First Republic, a third medium-level US bank, which between 10 March 2023 and 16 March 2023 had suffered from significant deposit outflows and stock decline, was temporarily stabilised after liquidity injections by 10 major US banks, but was finally closed by US regulators on 1 May 2023 and sold to JP Morgan Chase Bank.<sup>6</sup>

To address the wider market turmoil, which had affected interbank lending, the Fed and the US Treasury announced on 12 March 2023 the establishment of a Bank Term Funding Programme (BTFP), an additional mechanism for access to funding for eligible depository institutions, in a significant step to improve the liquidity of US banks.<sup>7</sup> Eligible institutions could access loans of up to 1 year from the facility using as collateral at par value assets eligible for purchase by the Federal Reserve in open market operations.

During the same period in Europe and, in particular, Switzerland, Credit Suisse, the second largest Swiss bank, was granted on 16 March 2023 by the Swiss National Bank (SNB) access to emergency liquidity of up to CHF 50 billion<sup>8</sup> (approximately USD 57,292,144). Credit Suisse had been in trouble for some time, and, in 2022, it had recorded the highest losses since the GFC. In the first quarter of 2023, the bank had faced shareholder resistance to its effort to

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<sup>1</sup>Board of Governors of the Federal Reserve, 'Financial Stability Report' (May 2023), 34, available at <<https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf>>.

<sup>2</sup>Idem.

<sup>3</sup>Ibid., 1.

<sup>4</sup>The percentage range of uninsured deposits for the period of 2018–2022 for SVB was 70%–80% of total deposits, almost double that of their peers, including large banks: United States Government Accountability Office (GAO), 'Preliminary Review of Agency Actions Related to March 2023 Bank Failures' (April 2023) (GAO-23-106,736) ('GAO Review'), available at <<https://www.gao.gov/assets/gao-23-106736.pdf>>.

<sup>5</sup>Federal Deposit Insurance Corporation, 'FDIC's Supervision of Signature Bank' (Press Release, 28 April 2023), 6, available at <<https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf>>.

<sup>6</sup>Federal Deposit Insurance Corporation, 'JPMorgan Chase Bank, National Association, Columbus, Ohio assumes all the Deposits of First Republic Bank, San Francisco, California' (Press Release, 12 May 2023), available at <<https://www.fdic.gov/news/press-releases/2023/pr23034.html>>.

<sup>7</sup>Financial Stability Report (above note 1), 53; GAO Review (above note 4), 2.

<sup>8</sup>Financial Stability Report (above note 1), 36.

recapitalise the bank and suffered significant deposit outflows.<sup>9</sup> The move of the Swiss Central Bank to provide the troubled bank with access to liquidity failed to calm the markets, and, on 19 March 2023, UBS, the largest Swiss bank, agreed to acquire Credit Suisse in a deal approved by Swiss regulators.<sup>10</sup> The failure of Credit Suisse was not attributed by Swiss authorities to external shocks, but to

‘...repeated incidents at the bank itself, primarily triggered by breaches of legal and supervisory obligations and shortcomings in risk management’.<sup>11</sup>

On 19 March 2023, the Fed and other central banks announced measures to provide additional liquidity to the global financial markets to ease the strain that was building in the system.<sup>12</sup> After the interventions of central government, the situation in the markets stabilised and deposit outflows from middle-level banks eased.

The events of March 2023 did not generate a full-blown financial crisis, mostly because the failed US banks did not have significant operations outside the USA and US regulators along with central banks moved swiftly to prevent escalation. However, the short-lived market turmoil attracted wider attention, because the crisis in the USA started not from some large, systemically important bank, but from medium-size banks,<sup>13</sup> whose failure normally does not result in regulator and central bank interventions. In the case of SVB and Signature, however, on 12 March 2023 in a joint statement, the Department of the Treasury, Federal Reserve and Federal Deposit Insurance Company (FDIC) announced the use of the systemic risk exception to least-cost resolution<sup>14</sup> for the two banks. The move allowed FDIC to guarantee the uninsured deposits of the two banks,<sup>15</sup> a move that reflected concerns of the US government that the two failures would spread to the wider market threatening financial stability.<sup>16</sup> To avoid using taxpayers’ funds, FDIC assumed the cost of the measures that were adopted for the resolution of the two banks and the protection of depositors, estimated to be USD 22.5 billion.<sup>17</sup>

The invocation of the systemic risk exception raised a number of questions and concerns, focusing among others<sup>18</sup> on the fact the two failed banks were not big enough to be ‘systemically important’; the fact that the exception focused only on the bailing out of uninsured depositors and not of the bondholders; on the potential of rise of moral hazard after the move, and on the passing of the cost of the resolution of the two banks to the rest of the sector through the use of FDIC funds, which are raised from contributions by all banks. Further questions emerged about the threshold, which could trigger public intervention in cases of bank failures

<sup>9</sup>Idem. Also Swiss National Bank, ‘Financial Stability Report 2023’ (June 2023) (‘Swiss FSR’), 23, available at <[https://www.snb.ch/en/i/about/pub/oecepub/id/pub\\_oecepub\\_stabrep](https://www.snb.ch/en/i/about/pub/oecepub/id/pub_oecepub_stabrep)>.

<sup>10</sup>FINMA, ‘FINMA approves merger of UBS and Credit Suisse’ (Press Release, 19 March 2023).

<sup>11</sup>Swiss FSR (above note 9), 23.

<sup>12</sup>Financial Stability Report (above note 1), 54.

<sup>13</sup>See <<https://www.federalreserve.gov/newsevents/testimony/barr20230328a.htm>>.

<sup>14</sup>The least-cost-resolution (LCR) principle aims to minimise the cost of bank resolution. For an analysis, see Congressional Research Service, ‘Bank Failures: The FDICs Systemic Risk Exception’ (IF12378, 11 April 2023). The exception allows FDIC, in exceptional circumstances, such as those invoked for SVB and Signature, to waive LCR, for which, see GAO Review (above note 4), 5–7.

<sup>15</sup>See Congressional Research Service, ‘Silicon Valley Bank and Signature Bank Failures’ (IN12125, 21 March 2023).

<sup>16</sup>Under US law (12 U.S.C. §1823(c)(4)(G)), the exception can be used when the bank failure ‘would have serious adverse effects on economic conditions or financial stability’.

<sup>17</sup>Financial Stability Report (above note 1), 53.

<sup>18</sup>For further analysis, see GAO review (above note 4), 12.

that do not appear to belong to the 'too-big-to-fail' group and whether the bailout of uninsured depositors in the two cases should be treated as a one-off event or as a reason to review the current policy on uninsured deposits.<sup>19</sup>

In the case of the rescue of Credit Suisse, market attention was paid to the fact that it was the first rescue of a systemically important bank since the GFC. Of greater interest, though, was the decision of Swiss regulators to write off, as part of the approval of the rescue deal with UBS, which also included liquidity support and state guarantee for potential losses of certain assets that UBS could suffer, of Credit Suisse's Additional Tier 1 (AT1) capital, without wiping out first shareholders' equity.<sup>20</sup> The latter received a partial bailout. The decision on AT1 appeared to be contradicting the common international practice, which is based on the hierarchy of claims in insolvency and which is to write down AT1 instruments after writing down shareholders' equity.<sup>21</sup>

FINMA justified the decision<sup>22</sup> to write down AT1 bonds first to the use in the case of Credit Suisse of extraordinary government support, which involved the liquidity assistance loans granted to the Bank on 19 March 2023 and which were secured by a federal default guarantee. According to FINMA, this support, in line with Swiss legislation, triggered the writing down of AT1 instruments, which must be written down before the equity capital of the bank concerned.<sup>23</sup> FINMA also stated that AT1 bonds were issued by public banks and held by institutional investors.<sup>24</sup> The decision attracted criticism and resulted in legal action by the affected bondholders, which is ongoing in the courts.<sup>25</sup>

The treatment of AT1 bondholders in the Credit Suisse case has similarities with the Yes Bank crisis in India. Yes Bank, one of India's largest private banks, wrote down INR 8,415 crore (approximately USD 1,010,916) worth of its AT1 bonds in March 2020.<sup>26</sup> AT1 bonds have regularly been issued by Banks in India, and they act as buffers for banks in times of stress and are perceived to be safer than equity shares of a bank.<sup>27</sup> The write-down of Yes Bank's AT1, however, was done without first writing down the common equity of the Bank, which held an inferior position to the AT1 bonds.<sup>28</sup> India's federal bank, which is the Reserve Bank of India (RBI), has identified the State Bank of India (SBI), ICICI Bank Ltd. and HDFC Bank Ltd. as Domestic Systemically Important Banks (D-SIBs).<sup>29</sup> For these banks, an additional equity requirement is applied. Yes Bank was not a D-SIB but had large deposits of more than INR 2 lakh crore (approximately USD 60 billion) and large asset base of over INR 2.2 lakh crore (approximately USD 60 billion).<sup>30</sup> The writing off of the AT1 bonds is now under litigation, and it will be

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<sup>19</sup>On 1 May 2023, FDIC published a report discussing the issues raised by uninsured deposits and the current deposit insurance scheme in the USA and considering options for reform.

<sup>20</sup>FINMA (above note 10).

<sup>21</sup>More detailed discussion is provided later in the article.

<sup>22</sup>FINMA, 'FINMA provides information about the basis for writing down AT1 capital instruments' (Press Release, 23 March 2023).

<sup>23</sup>Idem.

<sup>24</sup>Idem.

<sup>25</sup>See Robert Smith, Stephen Morris and Owen Walker, 'Credit Suisse bondholders force Swiss regulator to release AT1 wipe-out decree' (*Financial Times*, 18 May 2023).

<sup>26</sup>See: <<https://www.arx.cfa/~media/CA7F5BFF80D248E9AFC033E818BE03B3.ashx>>.

<sup>27</sup>RBI Press Release: 2019–2020/2028, 5, available at <<http://egazette.nic.in/WriteReadData/2020/218653.pdf>>.

<sup>28</sup>See above note 23.

<sup>29</sup>See: <[https://rbi.org.in/scripts/BS\\_PressReleaseDisplay.aspx?prid=54979](https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=54979)>.

<sup>30</sup>See: <<https://www.bqprime.com/opinion/yes-bank-crisis-could-rbi-have-done-this-differently>>.

interesting to see whether the apex court of India upholds the use of its discretionary power of the central bank to write off such bonds.<sup>31</sup>

All these cases raise questions about the performance of financial supervision. The problems of Credit Suisse had been well known before its downfall, and the same appeared to have been the case for SVB and Signature,<sup>32</sup> as well as Yes Bank.<sup>33</sup> Still, the supervisors of these banks failed to act to prevent the downfall of a SIB and a wider market crisis from the failure of two medium-sized US banks. Public trust in the banking system can be undermined not only by bank failures but also by the mediocre performance of bank supervisors.

The Indian banking sector had not been seriously affected by the GFC<sup>34</sup> or the recent bank crisis in the USA.<sup>35</sup> As a result, the country has been slower in reforming its own bank crisis management and resolution framework. However, more recently, as India has taken steps to further open its economy, the need for a more robust framework for managing bank failures closer to international standards has emerged.<sup>36</sup> In this context, India has recently taken steps to reintroduce with changes the Financial Resolution and Deposit Insurance (FRDI) Bill, which had been first introduced in 2017 but was withdrawn a year later.<sup>37</sup> The Bill aimed to incorporate international principles of bank crisis management and resolution into Indian law. The efforts to bring the Indian resolution framework for banks closer to international standards have, thus, been slow and staggered.

The European Union (EU) banks, on the other hand, had been severely affected by GFC,<sup>38</sup> and the EU was one of the jurisdictions, which adopted early on the post-GFC framework for crisis management and resolution of banks proposed by the Financial Stability Board (FSB). The main elements of that framework and the new institutional structure, which would oversee the supervision of EU banks and manage their resolution, were completed in 2014. On 18 April 2023, the European Commission published a package of proposals for the reform of the post-GFC framework,<sup>39</sup> aimed at addressing various identified weaknesses and the issues that emerged from the March 2023 events.

<sup>31</sup>See: <<https://www.reuters.com/world/india/india-top-court-extends-stay-order-quashing-write-off-yes-banks-at1-bonds-2023-03-03/>>.

<sup>32</sup>See <<https://www.reuters.com/business/finance/credit-suisse-how-did-it-get-crisis-point-2023-03-16/>>; <<https://abcnews.go.com/Politics/fed-aware-silicon-valley-bank-problems-year-collapse/story?id=97984436>>.

<sup>33</sup>In this case, the Asset Quality Review (AQR) conducted by RBI elucidated that the NPA of Yes Bank was seven times higher than the actual reported amount in their audit book. Shakeb Akhtar, Mahfooz Alam and Mohd. Mohsin Khan, 'YES Bank Fiasco: Arrogance or Negligence' (2021) 3(2) *Emerging Economies Cases Journal* 95–102, available at <<https://doi.org/10.1177/25166042211061003>>.

<sup>34</sup>India's banks had limited exposure to the US housing markets from where the GFC started and Indian banks had limited involvement risky international financial assets and derivatives. Furthermore, there was relatively low presence of foreign banks in India, which prevented the transmission of the crisis to the Indian economy. See also <<https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/SIGFUTH0809.pdf>> .

<sup>35</sup>See <<https://economictimes.indiatimes.com/markets/stocks/news/svb-collapse-a-rude-shock-but-indian-banks-well-insulated-to-not-get-trapped-in-chakravayuh/articleshow/98798279.cms?from=mdr>>.

<sup>36</sup>To read more about India's liberalization movement, see <<https://www.imf.org/external/pubs/ft/wp/2004/wp0443.pdf>>.

<sup>37</sup>For more details, see the section of the article on India.

<sup>38</sup>The EU had experienced a significant number of high-profile bank failures and significant market disruption, forcing the European Commission to allocate, during 2008–2011, EUR 4.5 trillion (or 37% of EU GDP at the time) to support its banks. See European Commission, 'New crisis management measures to avoid future bank bail-outs' (Press Release, Brussels, 6 June 2012), available at <[https://ec.europa.eu/commission/presscorner/detail/en/IP\\_12\\_570](https://ec.europa.eu/commission/presscorner/detail/en/IP_12_570)>.

<sup>39</sup>The documents of the reform package can be found at <[https://finance.ec.europa.eu/publications/reform-bank-crisis-management-and-deposit-insurance-framework\\_en](https://finance.ec.europa.eu/publications/reform-bank-crisis-management-and-deposit-insurance-framework_en)>.

In light of the above background, this article aims to discuss the lessons from the March 2023 market turmoil and consider how these lessons could result in appropriate regulatory responses in the related areas in two jurisdictions: India and the European Union. Although the two jurisdictions were not significantly affected by the market turmoil (no Indian or EU bank failed during the events), they are both in the process of updating their respective legal frameworks and the 2023 developments can contribute to shaping the direction of these developments.<sup>40</sup>

This article focuses on a critical review of the approaches adopted (or proposed under current reform proposals) by India and the EU on the following issues: the threat of systemic risks raised by medium-sized banks; the potential inclusion of medium-size banks into the scope of the review of systemic risks and bank resolution frameworks currently reserved for the large systemically important ones; the treatment of uninsured deposits in the case of bank failures; and the order of creditor claims in the case of bank resolution.

This article is structured as follows: Section 2 discusses the post-GFC reforms; Section 3 discusses the Indian framework, current and proposed before the March 2023 market turmoil, and some key concerns that have risen post-March 2023 and need regulatory attention; Section 4 discusses the main elements of the current EU framework on bank crisis management, resolution and deposit insurance; Section 5 discusses the lessons and significance of the March 2023 events for the laws of the two jurisdictions; and Section 6 summarises the key issues emerging and the way forward.

## 2 | THE POST-GFC INTERNATIONAL FRAMEWORK FOR CRISIS MANAGEMENT, BANK RESOLUTION AND DEPOSIT INSURANCE

The GFC resulted in wide ranging reforms to the existing crisis management, bank resolution and deposit insurance frameworks. The reforms aimed to correct major weaknesses identified during the crisis.

To improve the capitalisation and overall resilience of the banking system and to bolster risk coverage and management, the Basel Committee on Banking Supervision (BCBS) adopted a series of reforms with the new measures, among others, raising the required quality and quantity of capital in the banking system, enhancing risk coverage, introducing a revised leverage ratio to serve as a backstop to the risk-based regime, and introducing capital conservation and countercyclical buffers as well as a global standard for liquidity risk.<sup>41</sup>

The FSB, a new institution established by G20 to address financial stability issues post-GFC, undertook the shoring up of the bank crisis management and resolution regimes. A key characteristic of these reforms was the creation of a special resolution framework for large banks, whose failure was more likely to trigger systemic crises either globally or domestically and whose rescue through taxpayer bailouts during GFC proved extremely expensive and highly unpopular. The purpose of the new framework was aimed at preventing the failure of SIBs

<sup>40</sup>For example, in India, there is currently a debate about optimising the framework for deposit insurance, while in the EU, the European Commission's package for reform of the current framework of bank crisis management and deposit insurance (published in April 2023) includes similar proposals. All these proposals are discussed later in this article.

<sup>41</sup>Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems' (December 2010), available at <<https://www.bis.org/publ/bcbs189.pdf>>.



through early regulatory intervention and, if this failed to ensure the orderly winding-down of these banks, by preserving their core functions to ensure that there would be no disruption in the financial markets or threats to financial stability.<sup>42</sup> SIBs would be identified using a methodology developed by BCBS.<sup>43</sup> Also, these banks were subject to additional capital, liquidity and risk coverage requirements under Basel III.

Pre-GFC governments wishing to act swiftly to prevent market contagion had to resort to bailouts using public funds to prevent bank failures and to finance the costs of bank recovery. Resolution aims at addressing these perceived weaknesses. Some jurisdictions were operating resolution regimes for their banks even before the GFC, but the FSB found that those regimes lacked uniformity, mutual recognition and planning for stress and resolution, while facing challenges coordinating action with large and complex cross-border groups.<sup>44</sup> A new unifying legal regime, which would address in a comprehensive way all issues raised by bank distress involving SIBs, was proposed.

In 2011, FSB published its Key Attributes of Effective Resolution Regimes for Financial Institutions.<sup>45</sup> The framework contains a set of principles and processes for the prevention, early planning and management of resolution of SIBs, which aim to ensure that preventable banks failures can be addressed early and without the use of resolution, while non-preventable bank failures will be resolved in an orderly manner, with the core bank functions (e.g., access to deposits, loans) continuing during resolution, and without the use of taxpayers' funds. The cost of resolution will be financed by the industry and by passing to the private sector, shareholders and uninsured creditors, including uninsured depositors, the bank losses. The early action and the orderly management of bank failures will avoid systemic market disruptions.

To transfer the financial burden of the bank failures to the private sector, post-GFC reforms introduced the bail-in tool through, which bank shareholders and a range of junior and unsecured creditors, including uninsured depositors, would see their claims written down or converted to equity in case of a bank failure.<sup>46</sup> The losses for shareholders, uninsured and unsecured creditors must be imposed in a manner that respects the hierarchy of claims in insolvency.<sup>47</sup>

To reduce the risk of bank runs from retail depositors, who are more likely to initiate such runs and to cause market disruption, post-GFC reforms introduced the wider use of deposit insurance schemes funded by bank contributions,<sup>48</sup> which offer protection to retail depositors

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<sup>42</sup>See FSB, 'Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines', available at <[https://www.fsb.org/wp-content/uploads/r\\_101111a.pdf](https://www.fsb.org/wp-content/uploads/r_101111a.pdf)>.

<sup>43</sup>For systemically important banks with global presence, see Basel Committee on Banking Supervision, 'Global Systemically Important Banks: Revised Assessment Methodology and the Higher Loss Absorbency Requirement' (July 2018), available at <<https://www.bis.org/bcbs/publ/d445.pdf>>. The FSB publishes annually a list of globally systemically important banks. For banks that are systemically important domestically, BCBS has developed a separate framework, for which see Basel Committee on Banking Supervision, 'A Framework for Dealing with Domestic Systemically Important Banks' (October 2012), available at <<https://www.bis.org/publ/bcbs233.pdf>>.

<sup>44</sup>See FSB, 'Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines', 3–4, available at: <[https://www.fsb.org/wp-content/uploads/r\\_101111a.pdf](https://www.fsb.org/wp-content/uploads/r_101111a.pdf)>.

<sup>45</sup>See <[https://www.fsb.org/wp-content/uploads/r\\_141015.pdf](https://www.fsb.org/wp-content/uploads/r_141015.pdf)>. The framework was updated in 2014.

<sup>46</sup>For analysis and discussion of bail-in see Ulf Lewrick, José Maria Serena and Grant Turner, 'Believing in bail-in? Market discipline and the pricing of bail-in bonds' (BIS Working Paper No 819, 17 December 2019), available at <<https://www.bis.org/publ/work831.htm>>.

<sup>47</sup>FSB Key Attributes, s.3.5.

<sup>48</sup>See Basel Committee on Banking Supervision and International Association of Deposit Insurers, 'Core Principles for Effective Deposit Insurance Systems' (June 2009).

in all banks. The depositors receive a guarantee of their deposits up to a certain threshold. Full insurance coverage of all deposits is not favoured, because such an option will increase moral hazard, the propensity of banks to take excessive risks if they know that depositors will be compensated or that the bank will not be allowed to fail.<sup>49</sup> The deposit insurance schemes are also expected to play the additional and highly significant role as a source of funding in resolution or liquidation.<sup>50</sup>

For the resolution of banks that are systemically important at national level, BCBS published a legal framework in October 2012.<sup>51</sup> This framework covers bank failures with significant impact on the national economies and passes responsibility for the relevant the assessments to the national authorities.<sup>52</sup> While failures of D-SIBs can cause market disruption and financial instability similar to the large banks with significant cross-border presence, the cross-border spill-over is usually limited. The resolution framework for those banks is based on the same principles as the one for global SIBs with some adjustments to reflect their more national focus.<sup>53</sup>

Banks, which are not considered systemically important, remain subject to the existing national regimes, for which laws are not harmonised. Some jurisdictions use some type of bank-specific resolution mechanism typically seeking to maintain the core bank functions when the failing bank is deemed important for the economy and national interest, while sending to insolvency and through it to liquidation those deemed less important.<sup>54</sup> Other jurisdictions do not operate bank-specific resolution regimes, but use instead the legal frameworks for corporate insolvencies.<sup>55</sup> In some cases resolution and insolvency are covered under a single legal framework.<sup>56</sup> In practice, combining resolution and insolvency, when part of the bank is maintained while the rest is liquidated has also been widely used. Sources of financing for the resolution of banks also vary with public funds still being used. The BCBS framework for D-SIGs banks has influenced national laws in several jurisdictions.

Overall, even though smaller banks fail in greater numbers than the large banks<sup>57</sup> and they are often instrumental in spreading financial crises or exacerbating their harmful effects, they have received relatively limited attention post-GFC, as the focus shifted towards the larger SIBs. The failures of SVB and Signature, two medium-size US banks, which forced FDIC to invoke the systemic risk exception and provoked wider market intervention by the Federal Reserve and other central banks, serve as a reminder that the public confidence in the financial system remains fragile and that a failure of smaller banks can still undermine it to an extent that could lead to wider bank runs and financial crisis.

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<sup>49</sup>Ibid., 9.

<sup>50</sup>The issue is explored later in the article. See also Patrizia Baudino et al., 'Bank Failure Management – the Role of Deposit Insurance' (FSI Insights on Policy Implementation No. 17, 2019), 20–22.

<sup>51</sup>Basel Committee on Banking Supervision, 'A Framework for Dealing with Domestic Systemically Important Banks' (October 2012), available at <<https://www.bis.org/publ/bcbs233.pdf>>.

<sup>52</sup>Ibid., 2.

<sup>53</sup>Idem.

<sup>54</sup>For more details, see Patrizia Baudino et al., 'How to manage failures of non-systemic banks? A review of country practices' (FSI Insights on Policy Implementation No. 10 October 2018).

<sup>55</sup>Ibid., 6–7.

<sup>56</sup>Above note 46.

<sup>57</sup>In the USA, the Great Depression of 1929–1933 resulted in the closing of 9,755 banks of all sizes. During the financial crises of the 1980s and 1990s, 1,617 federally insured banks were closed, while more recently during 2008–2013, in the aftermath of GFC, more than 500 banks shared the same fate, for which see FTC, 'Managing the Crisis: The FDIC and RTC Experience' (Vol.1), 4; FDIC, 'Crisis and Response: An FDIC History 2008/2013' ('FDIC History'), xii.

### 3 | THE BANK RESOLUTION AND DEPOSIT INSURANCE FRAMEWORK IN INDIA

The insolvency and resolution framework for Indian banks gained momentum in light of increasing non-performing assets (NPAs).<sup>58</sup> There have been committee reports, such as that of the Sashakt Committee,<sup>59</sup> which have proposed a focused framework for handling NPA issues in banks. In response to these market developments, there have been ongoing deliberations and a few notable actions, including the proposal to introduce a new law, namely, the FRDI Bill, which aimed to incorporate into Indian law the FSB key attributes.<sup>60</sup>

#### 3.1 | India's merger approach to resolution

The Indian approach to bank failures includes a pre-insolvency and an insolvency stage. Currently, India has a number of pre-insolvency resolution options for banks. These include, among others, debt restructuring, strategic debt restructuring, a prudential framework, a scheme for sustainable stressed asset restructuring options, etc.<sup>61</sup> However, historically, what has been popular, as both a pre-insolvency and post-insolvency procedure, is the 'merger' solution to handle stress in Indian banks. There have been instances where a failed individual bank, such as Lakshmi Vilas, was merged with DBS Bank.<sup>62</sup> There were also instances where small public banks were merged into larger public banks to provide them with more stability<sup>63</sup> and to consolidate the banking sector.

This approach can be traced to the Indian policy, which favoured a publicly controlled, closed banking sector until 1992. During that period, the idea of market forces governing the bank failure outcome was not welcomed. The market was also fragmented and dominated by small- and medium-sized banks. Later, following recommendations of the Narsimha Committee Report, India decided to open its market to private banks.<sup>64</sup> It had been suggested that India should have fewer but stronger Public Sector Banks (PSBs). Since 2016, effective action has been undertaken to consolidate PSBs by the amalgamation of five associate banks of the SBI and Bharatiya Mahila Bank (BMB) into the SBI.<sup>65</sup> Earlier, in 2004, the Indian Banking Association (IBA) report suggested corporatisation of PSBs to accelerate the process of consolidation.<sup>66</sup> In 2008, a Planning Commission Report also stated that given the fragmented nature of the Indian banking system and the small size of the typical bank, there was a need to encourage but not

<sup>58</sup>For more discussions, see <<https://indianeconomy.columbia.edu/sites/default/files/content/201904-Chari%20et%20al-NPA%20Crisis.pdf>>. See also Anusha Chari et al., 'The Origins of India's NPA Crisis' (Columbia SIPA, Deepak and Neera Raj Center on Indian Economic Policies Working Paper No. 2019-04), available at <<https://policycommons.net/artifacts/1673502/working-paper-no/2405151/>>.

<sup>59</sup>For more discussion, see <[https://www.argus-p.com/uploads/blog\\_article/download/1550047638\\_ica---project-sashakt---\(060818\)\\_v2.pdf](https://www.argus-p.com/uploads/blog_article/download/1550047638_ica---project-sashakt---(060818)_v2.pdf)>.

<sup>60</sup>See <[https://loksabhadocs.nic.in/Refinput/New\\_Reference\\_Notes/English/THE%20FINANCIAL%20RESOLUTION%20AND%20DEPOSIT%20INSURANCE%20BILL,%202017.pdf](https://loksabhadocs.nic.in/Refinput/New_Reference_Notes/English/THE%20FINANCIAL%20RESOLUTION%20AND%20DEPOSIT%20INSURANCE%20BILL,%202017.pdf)> .

<sup>61</sup>See <<https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-2/article/india>>.

<sup>62</sup>See <[https://www.dbs.com/newsroom/Amalgamation\\_of\\_Lakshmi\\_Vilas\\_Bank\\_with\\_DBS\\_Bank\\_India\\_Limited](https://www.dbs.com/newsroom/Amalgamation_of_Lakshmi_Vilas_Bank_with_DBS_Bank_India_Limited)>.

<sup>63</sup>See <<https://economictimes.indiatimes.com/opinion/et-commentary/why-bank-mergers-are-good-for-reducing-npas/articleshow/92732863.cms?from=mdr>>.

<sup>64</sup>See <<https://ibbi.gov.in/uploads/resources/Narasimham%20Committee%20I-min.pdf>>.

<sup>65</sup>See <[https://loksabhadocs.nic.in/Refinput/New\\_Reference\\_Notes/English/MergerofPSBs.pdf](https://loksabhadocs.nic.in/Refinput/New_Reference_Notes/English/MergerofPSBs.pdf)>.

<sup>66</sup>Idem.

force sector consolidation.<sup>67</sup> In 2014, the Nayak Committee further emphasised the importance of governance in PSBs and, thus, stated that the decision of a merger or an amalgamation in the PSBs must be through the respective boards of the banks keeping in view the synergies and benefits of mergers.<sup>68</sup>

Recently, ten PSBs were merged into four banks in India, as a result of the powers under the Banking Regulation Act, 1949.<sup>69</sup> The Government of India, while announcing the merger plan, suggested that

‘The adoption of best practices across amalgamating entities would enable the banks to improve their cost efficiency and risk management’.

The press note by the government clarified that the same was done under The Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980, which allow the Central Government, in consultation with RBI, to make a scheme for the amalgamation of any nationalised bank with any other nationalised bank or any other banking institution.<sup>70</sup>

It also noted that various committees in the past, including the Narasimhan Committee (1998), constituted by RBI, the Leela Dhar Committee (2008), chaired by the RBI Deputy Governor, and the Nayak Committee (2014), constituted by RBI, which have recommended consolidation of PSBs, given underlying benefits and synergies.<sup>71</sup> Taking note of this and potential benefits of consolidation for the banks, as well as for the public at large through enhanced access to banking services, the Indian government, with a view to facilitating consolidation among PSBs to create strong and competitive banks, serving as catalysts for growth, with an improved risk profile of the bank, implemented an approval framework for proposals to amalgamate PSBs through an Alternative Mechanism (AM).<sup>72</sup>

More than 2 years have elapsed since the mega-merger and the impact assessment in the literature appears to be divided. While certain studies suggest that NPAs of weak merging banks declined by 10%, almost entirely due to a decline in strategic defaults,<sup>73</sup> some researchers, on the other hand, argue that

‘the merger decisions were not necessarily on efficiency grounds, and hence, post-merger benefits are minimal’.<sup>74</sup>

Moreover, since most of the Indian PSBs have a statutory basis, their respective statutes often provide for a resolution mechanism. The power under statute, most often than not, exempts these banks from winding up under the Companies Act and the liquidation of these banks can

<sup>67</sup>The Report is available at: <<http://164.100.161.239/reports/genrep/ar0809eng.pdf>>.

<sup>68</sup>The Report is available at: <<https://www.dcsmc.gov.in/publications/comitterep/nayak.html>>.

<sup>69</sup>See <<https://economictimes.indiatimes.com/news/economy/policy/mega-merger-of-state-run-banks-comes-into-force-from-april-1-says-rbi/articleshow/74868213.cms?from=mdr>> .

<sup>70</sup>See: <<https://pib.gov.in/newsite/PrintRelease.aspx?relid=186420>>.

<sup>71</sup>Idem.

<sup>72</sup>Above note 65.

<sup>73</sup>Nishant Kashyap, Srinivas Mahapatro and Prasanna Tantri, ‘How does the Rescue of Weak Banks through Mergers impact Loan Performance? Evidence From India’ (12 July 2022), available at <<https://ssrn.com/abstract=4160936>>; <<https://doi.org/10.2139/ssrn.4160936>>.

<sup>74</sup>Abhiman Das and Subal Kumbhakar, ‘Bank Merger, Credit Growth, and the Great Slowdown in India’ (2022)

57 *Economic and Political Weekly* 58–67.

happen under by an order of the central government.<sup>75</sup> The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, also provides for exemption from laws on winding up of companies and states that only an order of Central Government can lead to the winding up of the banks nationalised under those Act.<sup>76</sup>

Thus, most of the recommendations to strengthen Indian banks and reduce bank failures favoured the ‘merger’ approach, which includes also healthy banks. Experts have argued that the recent merger would definitely create more systematically important banks (12 large state-owned banks in place of 27 large-, medium- and small-sized banks), which would not be allowed to fail during a major financial crisis.<sup>77</sup> This implicit bailout guarantee may make the managers of these banks ‘less careful’ in taking credit decisions enhancing moral hazard risks. Such an attitude may further deteriorate the asset quality of these banks.<sup>78</sup> There has also been three notable bank failures in recent times. One, Lakshmi Vilas Bank (LVB), was amalgamated with DBS after the RBI scheme proposed writing off the entire capital and reserves post-merger.<sup>79</sup> In another case, Yes Bank shareholders had to settle for a dilution of their holdings after the SBI and a few other banks infused capital, with a three-year lock-in being imposed.<sup>80</sup>

Overall, the typical resolution methods used in India are assisting the troubled bank by restructuring it or merging it with a strong institution, or closure. Partial closure and liquidation of assets may also be used as part of a merger or restructuring. The most common method has been assisted or compulsory merger when the troubled bank is merged with another bank, usually a PSB. There were also cases of voluntary mergers where a healthy bank voluntarily took over a weak or distressed bank.

Apart from making pay-outs to banks that are put under liquidation, the Deposit Insurance and Credit Guarantee Corporation (DICGC)<sup>81</sup> assists in mergers by meeting the shortfalls in depositors’ claims up to the coverage limit when the acquiring bank is unable to meet this liability. In case of smaller urban cooperative banks (UCBs), the general approach has been to liquidate the bank with reimbursement made to depositors.

### 3.2 | Moving away from the past: Exploring other resolution options

Around the time of the GFC, the government did recognise the special nature of FSPs, by establishing the Financial Sector Legislative Reforms Commission (FSLRC)<sup>82</sup> in March 2011. The

<sup>75</sup>For example, Article 45, State Bank of India Act, 1955 exempts the State Bank of India from any laws relating to the winding up of companies.

<sup>76</sup>Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, §18A; Life Insurance Corporation Act, 1956, §§38–59. For more discussion, see Pratik Datta, Varun Marwah and Ulka Bhattacharyya, ‘Resolving Financial Firms in India: The Way Forward’ (2020) 13 *NUJS L Rev* 1.

<sup>77</sup>See <<http://indiafa.org/implications-of-recent-bank-mergers/>>.

<sup>78</sup>Idem.

<sup>79</sup>See <<https://rbidocs.rbi.org.in/rdocs/content/pdfs/DraftS17112020.pdf>>.

<sup>80</sup>See <<https://www.livemint.com/opinion/online-views/india-needs-to-reform-the-way-it-handles-bank-failures-11678857540577.html>>. More information can be found at <[https://www.icidirect.com/maillimages/IDirect\\_YesBank\\_CoUpdate\\_Mar23.pdf](https://www.icidirect.com/maillimages/IDirect_YesBank_CoUpdate_Mar23.pdf)>.

<sup>81</sup>DICGC is a specialised division of Reserve Bank of India (RBI). It was established on 15 July 1978 under the Deposit Insurance and Credit Guarantee Corporation Act, 1961, for the purpose of providing insurance of deposits and guaranteeing of credit facilities. It insures all bank deposits, such as saving, fixed, current, recurring deposit for up to the limit of INR 500,000 of each depositor in a bank.

<sup>82</sup>Above note 72.

FSLRC, constituted by the Ministry of Finance in March 2011, was asked to comprehensively review and redraw the legislations governing India's financial system.<sup>83</sup> The product of the deliberations done by FSLRC resulted in the draft 'Indian Financial Code',<sup>84</sup> which was intended to put into place a comprehensive financial law, including resolution in financial distress. Later on, this report proved to be a significant source for the 'Committee to Draft Code on Resolution of Financial Firms'<sup>85</sup> to come out with the FRDI Bill. Around the same time, in 2013, RBI had also constituted a Working Group to suggest a separate resolution framework for FSPs in India. However, after the reference of the FRDI Bill to the Joint Committee,<sup>86</sup> it was withdrawn owing to a variety of reasons, including the public backlash towards bail-in as a resolution instrument, lack of review or appeal mechanism for redressal of grievances of the affected parties and others.<sup>87</sup>

Furthermore, this sectoral regime is problematic on a lot of fronts, ranging from absence of identification of an ideal trigger to initiate resolution to the ambit of such resolution powers. One prominent instance is the power under section 45 of the Banking Regulation Act, 1949, that empowers the RBI to apply to Central Government for suspension of the business of the banking company, which is followed by a preparation of a scheme of reconstruction of the banking company or its amalgamation with another bank. Under these powers, banks in India have been forcibly merged into other banks with a view to taking them temporarily out of stress, as discussed above. This method of dealing with failing banks is not only devoid of a proper intervention point for resolution, but also devoid of the variety of alternative ways to restructure prominent financial institutions.

For banks that fail to meet the minimum prescribed requirements, the RBI institutes a regular monitoring mechanism. The weak bank is required to put in place a plan of action indicating targets for critical financial parameters, including capital infusion. If weakness in the bank persists with net worth turning negative and there is no credible action plan for a turnaround, it is put under a moratorium. The purpose of imposing a moratorium is to prevent a run on the bank, stop asset stripping and give time to the regulators to identify a suitable strong bank for takeover. The process of merger is put through as expeditiously as possible in a transparent and consultative manner. Importantly, in the Reserve Bank, we have a committee of the Board for Financial Supervision, which reviews bank supervisory function and monitors the performance of banks, especially weak banks.

### 3.3 | The proposed new framework

The FRDI Bill is the most recent proposed legislative reform, pertaining to resolution in the financial sector, as it establishes a single unified framework for resolving certain categories of

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<sup>83</sup>See <<https://prsindia.org/policy/report-summaries/financial-sector-legislative-reforms-commission>>.

<sup>84</sup>Idem.

<sup>85</sup>Above note 71.

<sup>86</sup>For details of the report, see <[https://prsindia.org/files/bills\\_acts/bills\\_parliament/2017/Joint%20Committee%20Report%20on%20the%20FRDI%20Bill%202017.pdf](https://prsindia.org/files/bills_acts/bills_parliament/2017/Joint%20Committee%20Report%20on%20the%20FRDI%20Bill%202017.pdf)>.

<sup>87</sup>See <<https://www.livemint.com/Industry/Ff29jhSKgcOxZkjkpHY5K/Govt-withdraws-FRDI-Bill-from-Lok-Sabha.html>>. Also, note that financial institutions in India are resolved by the regulatory authority, which has the primary supervisory responsibility, and which exercises its powers under its parent statute. Examples include the powers granted to the RBI and the Central Government under the Banking Regulation Act of 1949 and the powers granted to the Insurance Regulatory & Development Authority under the Insurance Act of 1938.

FSPs in distress.<sup>88</sup> It seeks to provide deposit insurance to consumers of certain categories of financial services and a mechanism for designation of Systemically Important Financial Institutions ('SIFIs') by the Central Government for resolution.<sup>89</sup> Although the Bill was initially withdrawn owing to public backlash over bail-in provision,<sup>90</sup> the government intends to reintroduce it with changes.<sup>91</sup>

Under this proposed regime, there are essentially two authorities involved throughout the process of resolution, namely, the Resolution Corporation,<sup>92</sup> which exercises the core resolution powers and is the Resolution Authority; and the Appropriate Regulator,<sup>93</sup> which is a financial service regulator of the respective provider and assists the Resolution Corporation in the process leading up to resolution.

The FRDI Bill provides safeguards to protect creditors and ensure continuity of critical functions of the firm. Reflecting FSB recommendations when resolving a firm through bail-in, the Corporation will have to ensure that none of the creditors (including bank depositors) receive less than what they would have been entitled to receive if the firm were to be liquidated. But this proves challenging, especially due to the conditions in Indian markets. Banks face inherent interest rate risks, since the market value of fixed-rate loans falls with a rise in interest rates. Their financial leverage is also higher than non-financial firms, which is evidenced by their high debt to equity ratio. They are significantly less liquid, evidenced by their low cash to total asset ratio. The proposed FRDI Bill allows a liability to be cancelled or converted under bail-in only if the creditor has given his consent to do so in the contract governing such debt.

Given the Credit Suisse experience, it will be pertinent to clarify in the law the treatment of creditors vis-à-vis the shareholders and to ensure that public intervention follows the prescribed processes and ideally the international practices. Such a clarification would make more difficult for the Indian government to justify a policy diversion even in the case of resolution of banks of high public significance.

The resolution regime must operate alongside the deposit protection regime. The concern for India is not limited to insured depositors alone. As per the Economic Survey 2021–2022, 49.1% of the total deposits held with Indian banks are not covered by the deposit insurance cover available under the Deposit Insurance and Credit Guarantee Corporation (DICGC) scheme, which is a specialised division of RBI under the jurisdiction of the Ministry of Finance, Government of India.<sup>94</sup> In terms of absolute amounts, this is INR 73.5 lakh crore worth of

<sup>88</sup>Preamble, FRDI Bill.

<sup>89</sup>Idem.

<sup>90</sup>Statement of Reasons for withdrawal of 'The Financial Resolution and Deposit Insurance Bill, 2017' under Direction 36 of the Directions of the Speaker, Lok Sabha.

<sup>91</sup>See <<https://indianexpress.com/article/business/banking-and-finance/modified-frdi-bill-up-for-discussions-7702781/>>.

<sup>92</sup>Section 3(1), FRDI Bill, provides that: "The Central Government shall, by notification, establish for the purposes of this Act, a Corporation by the name of the Resolution Corporation. The Corporation shall be a body corporate, by the name aforesaid, having perpetual succession and a common seal with power, subject to the provisions of this Act, to acquire, hold or dispose of property." For further information on the Resolution Corporation, see Chapter 2, FRDI Bill.

<sup>93</sup>As per section 2(2), FRDI Bill: "appropriate regulator" means "a financial sector regulator specified under the First Schedule, and includes financial sector regulators where the specified service provider is regulated by more than one financial sector regulator; and in that case, such regulators shall, from amongst them, designate a lead regulator by entering into a memorandum of understanding, and in case of any disagreement, the Central Government may designate a lead regulator."

<sup>94</sup>Economic Survey, India 2021–2022, available at <file:///Users/heetis/Downloads/Economic%20Survey%20Complete%20PDF%20(1).pdf>, 132.

deposits without the DICGC insurance cover. The protection of uninsured depositors, as the cases of SVB and Signature in the USA showed, is an important issue, with wider and economic and social significance. While deposit insurance cannot and should not bail out all uninsured depositors, establishing the right threshold for uninsured deposits and ensuring that Indian banks do not excessively rely on such deposits would reinforce financial stability, which reducing moral hazard.

### 3.4 | Risk classification

Under FRDI, the Resolution Corporation, is an independent Resolution Corporation tasked with resolving failed financial firms. The Corporation will also subsume the deposit insurance function presently performed by the Deposit Insurance and Credit Guarantee Corporation.<sup>95</sup>

Chapter 8 of the FRDI Bill, 2017, provides for a five-stage risk classification for financial institutions based on attributes such as asset quality, adequacy of capital, assets and liabilities and capability of management.<sup>96</sup> Every risk classification is to be done by the Resolution Corporation. For risk classification, a number of criteria including the adequacy of capital, assets and liability, asset quality, capability of management, earnings sufficiency, leverage ratio, liquidity of the specified service provider, sensitivity of the specified service provider to adverse market conditions, compliance with applicable laws, risk of failure of a holding company of a specified service provider or a connected body corporate in India or abroad, etc., are to be taken into account.<sup>97</sup> The Bill provided that an institution (in course of discussion of this paper, assume it is a bank) classified in the category of material or imminent risk to viability shall submit a restoration plan to the appropriate regulator and a resolution plan to the within 90 days of such classification under Section 36.<sup>98</sup>

Furthermore, it provided that the Resolution Corporation may create a bridge service provider by incorporating a company for the purpose of resolving a specified service provider, with the aim of eventual resolution and that the shares of the bridge service provider can be entirely held by the corporation.<sup>99</sup> Furthermore, Section 38 of the Bill provides that if a provider is classified as material or imminent risk to viability, as the case maybe, such covered service provider shall submit a Restoration Plan to the Appropriate Regulator and a Resolution Plan to the Corporation within 30 days of such classification. Furthermore, every covered service provider designated as a SIFI shall submit a Resolution Plan and Restoration Plan to the Corporation and the Appropriate Regulator respectively, within 90 days of such designation.<sup>100</sup>

A copy of every Resolution Plan submitted to the Resolution Corporation is then sent to the Appropriate Regulator, and a copy of every Restoration Plan submitted to the Appropriate Regulator is sent to the Corporation within 50 days of its receipt.<sup>101</sup> Similarly, the resolution plan needs to be submitted every 6 months to the appropriate regulator and to the Resolution Corporation.<sup>102</sup> The Plan covers distinct identification of the assets and liabilities of the covered

<sup>95</sup>See <<https://blog.theeapjournal.org/2017/06/movement-on-law-for-resolution.html#gsc.tab=0>>.

<sup>96</sup>See sections 37 and 38, FRDI Bill.

<sup>97</sup>Ibid., Section 36.

<sup>98</sup>Ibid., Section 37.

<sup>99</sup>Ibid., Section 50.

<sup>100</sup>Ibid., Section 39.

<sup>101</sup>Ibid., Sections 39 and 40.

<sup>102</sup>Ibid., Section 42.



service provider, any contingent liabilities of the covered service provider, distinct identification of critical functions of an insurer; distinct identification of critical shared services, direct or indirect access to Financial Market Infrastructure services; and such other relevant information, including strategy. In the event that the financial service provider, that is, banks, undergoes bankruptcy situation, this plan sets in.

The Resolution Corporation is empowered to take action by a bail-in instrument or a scheme to induce more capital, as the case may be.<sup>103</sup> 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. Like in the EU, under the proposed Bill, the Resolution Corporation was empowered to effectuate bail-in by internally restructuring the firm's debt by:

- i. cancelling liabilities that the firm owes to its creditors, or
- ii. converting its liabilities into any other instrument (e.g., converting debt into equity), among others.<sup>104</sup>

The Bill clarified that the power of the Corporation, while using bail-in to resolve a firm, will be limited. There were safeguards provided for the protection of interest of creditors. When resolving a firm through bail-in, the Corporation will have to ensure that none of the creditors (including bank depositors) receive less than what they would have been entitled to receive if the firm was to be liquidated.<sup>105</sup> Liability under bail-in could be cancelled or converted, only if the creditor has given his consent to do so in the contract governing such debt.<sup>106</sup> The terms and conditions of bank deposits will determine whether the bail-in clause can be applied to them.

At a policy level, there needs to be a clear delineation of responsibilities between the appropriate authority and the resolution authority since their roles may often conflict.<sup>107</sup> The prudential supervisor which is the appropriate authority would be more inclined to bring back the FSP to health through supervisory processes while the resolution authority would prefer earliest intervention to preserve value through resolution. The financial resolution framework should clearly stipulate the information and expertise sharing arrangements with the resolution authority in good times, and the specific point at which the resolution authority can step in to take corrective or resolution measures.<sup>108</sup>

Conceptually, there could be four main types of ex post resolution tools. First, the resolution authority could act as a receiver which steps in and arranges for a liquidation of the assets of the financial institution. The resolution authority could sell the assets at a considered pace to avoid fire sale contagion. Insured depositors could be paid from the deposit insurance fund. However, such liquidation could destroy considerable value in some cases.

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<sup>103</sup>Ibid., Section 52.

<sup>104</sup>Ibid., Section 52.

<sup>105</sup>Ibid., Section 55.

<sup>106</sup>Idem.

<sup>107</sup>Above note 103.

<sup>108</sup>Datta, Marwah and Bhattacharyya (above note 76).

### 3.5 | The issue of insured deposits in India

Deposit insurance scheme was introduced in India in 1961.<sup>109</sup> It was in 1960 that the failure of Laxmi Bank and the subsequent failure of the Palai Central Bank catalysed the introduction of deposit insurance in India.<sup>110</sup>

Presently, the number of fully protected accounts at the end of March 2022 constituted 97.9% of the total number of accounts. In terms of amount, the total insured deposits, as of the end of March 2022, constituted 49.0% of assessable deposits. This is higher than the guidance of the International Association for Deposit Insurance (IADI), which recommends coverage of a number of accounts up to 80% and 20–30% in value terms. As per the core principle of effective deposit insurance, cover should be limited, be credible, cover the vast majority of deposits, and be subject to market discipline. The cover given by DICGC is according to this principle.<sup>111</sup>

The major reason for the public's backlash towards the FRDI Bill was due to the lack of understanding and apprehension towards the perceived misuse of insured deposits in the Bill. According to Chapter IV of the FRDI Bill, deposit insurance and largely deals with determination of amount payable by the Corporation to a depositor on account of deposit insured.<sup>112</sup> The Bill provides that the Corporation Insurance Fund shall be utilized for payment to a depositor of an insured service provider (ISP) in respect of his deposit in case of its liquidation. If the Resolution Corporation is dealing with the resolution of an ISP, then the Corporation may decide to invite offers from other such providers to take over the liabilities, deposits or realisable assets of the concerned provider.<sup>113</sup>

### 3.6 | Initiation of the resolution process

From the perusal of the Bill, the process of initiation of the insolvency process against the banks is unclear. Even though the insolvency process against the bank provider is to be initiated only on an application filed by the RBI, which is the appropriate regulator,<sup>114</sup> it is uncertain, under what circumstances, the RBI can file the application with the National Company Law Tribunal (NCLT). The FSB key attributes require<sup>115</sup> clear standards or suitable indicators of non-viability to help guide decisions on whether firms meet the conditions for entry into resolution.

<sup>109</sup>See <[https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/dicgc\\_act.pdf](https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/dicgc_act.pdf)>. In 2021, the law was amended to make DICGC liable to pay the insured deposit amount to depositors of an insured bank in event of the following:

(i) liquidation, that is, sale of all assets on closing down of the bank, (ii) reconstruction or any other arrangement under a scheme, or (iii) merger or acquisition by another bank, that is, transferee bank. Once the Corporation makes the payment to the depositors, the liquidator or the insured or transferee bank (as the case may be) becomes liable to repay the same amount to the Corporation. The amount paid by the Corporation in respect of a deposit reduces its liability against the deposit.

<sup>110</sup>See <[https://rbi.org.in/history/Brief\\_Fun\\_DepositInsurance.html#:~:text=It%20was%20in%201960%20that,President%20on%20December%207%2C%201,961](https://rbi.org.in/history/Brief_Fun_DepositInsurance.html#:~:text=It%20was%20in%201960%20that,President%20on%20December%207%2C%201,961)>.

<sup>111</sup>Idem.

<sup>112</sup>Above note 102.

<sup>113</sup>See <[https://loksabhadocs.nic.in/Refinput/New\\_Reference\\_Notes/English/THE%20FINANCIAL%20RESOLUTION%20AND%20DEPOSIT%20INSURANCE%20BILL,%202017.pdf](https://loksabhadocs.nic.in/Refinput/New_Reference_Notes/English/THE%20FINANCIAL%20RESOLUTION%20AND%20DEPOSIT%20INSURANCE%20BILL,%202017.pdf)>.

<sup>114</sup>Ministry of Corporate Affairs, Notification dated 18 November 2019, S.O. 4,139(E).

<sup>115</sup>See: <[https://www.fsb.org/wp-content/uploads/r\\_111104cc.pdf](https://www.fsb.org/wp-content/uploads/r_111104cc.pdf)>.

Countries have attempted to define SOAR<sup>116</sup> and PAIRS<sup>117</sup> risk assessments to identify the non-viability of a failing financial firm. It is desirable that the regulations clearly define them so that the respective authority has the power to step in timely before the financial firm becomes balance sheet insolvent.

One safeguard that the resolution process has for the creditors is that when resolving a firm through bail-in, the Corporation will have to ensure that none of the creditors (including bank depositors) receive less than what they would have been entitled to receive if the firm was to be liquidated.<sup>118</sup>

Further, the Bill provides that every covered service provider designated as a SIFI shall submit a Resolution Plan and Restoration Plan to the Corporation and the Appropriate Regulator respectively, within 90 days of such designation.<sup>119</sup> It should contain distinct identification of the assets and liabilities of the specified service provider. It should list down any contingent liabilities of the specified service provider.<sup>120</sup> It should also provide the steps that the specified service provider plans to take to qualify for classification in the category of at least moderate risk to viability and how such steps may result in such classification.

At the same time, the financial institution is required to submit a resolution plan to the Corporation. The aim of resolution plan is to ensure the orderly resolution of the bank while maintaining its critical functions and protecting financial stability. Like the restoration plan, the resolution plan should contain the distinct identification of the assets and liabilities of the specified service provider, any contingent liabilities of the specified service provider, distinct identification of critical functions of the specified service provider, direct or indirect access to financial market infrastructure services and strategy plans to exit the resolution process.

The latter may provide for the consideration of legal or regulatory requirements as may be required by the Corporation to sell or transfer the assets and liabilities of the specified service provider, or change its ownership, etc.

The resolution plan is required to be revised annually and the Corporation and the appropriate regulator shall be informed of such revised resolution plan within 7 days of such revision. Furthermore, any material change in the too needs to be informed to the Corporation.<sup>121</sup>

### 3.7 | The outcome of the resolution process

The Resolution Corporation may resolve a bank classified in the category of critical risk to viability through a scheme or a bail-in instrument.<sup>122</sup> Bail-in could be exercised by either cancelling a liability owed, or modifying or changing the form of a liability owed or through a contract or agreement under which a specified service provider has a liability shall have effect as if a specified right had been exercised under it.<sup>123</sup> Thus, the financial institution could cancel or modify any securities or convert any such securities from one class to another, including the creation of a new security in modification of an existing security. It could also make provision

<sup>116</sup>Supervisory Oversight and Response System (SOARS).

<sup>117</sup>Probability & Impact Rating System (PAIRS).

<sup>118</sup>Section 55, FRDI Bill.

<sup>119</sup>*Idem*.

<sup>120</sup>*Ibid.*, Section 40.

<sup>121</sup>*Ibid.*, Section 52.

<sup>122</sup>*Idem*.

<sup>123</sup>*Ibid.*, Section 62.

with respect to the rights attaching to securities issued including the specified rights attaching to securities are to be treated as having been exercised. The Bill provided for legislative check by mandating that the details of bail-in plan be sent to the central government which in turn be laid before each House of Parliament.<sup>124</sup>

In case the financial institution undergoes liquidation as the most appropriate method for the resolution, it would make an application to the Tribunal for an order of liquidation in respect of such specified service provider.<sup>125</sup> Within a period of 14 days from the date on which an application, Tribunal should pass an order of liquidation and appoint the Corporation as a liquidator. On the appointment of the liquidator, all powers of the board of directors, key managerial personnel and the partners of the specified service provider, shall cease to have effect and shall vest in the liquidator.<sup>126</sup> There is limited scope for appeal against the Tribunal's decision. The liability of an ISP to pay premium ceases upon the appointment of the Corporation as the liquidator.

### 3.8 | FRDI bill evaluation

In order to provide orderly wind-down of failed banks and to fully protect financial stability, a banking crisis management and 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 and not only failures of large complex financial institutions. Post-GFC, the focus of the regulations has been the banks that could cause systemic risk mainly because these banks emerged as a new and sizeable threat to financial stability. Following this approach, the RBI too focused mostly on the domestically SIBs. However, the SVB and Signature failures showed that there is need to expand the focus of crisis management on even stand alone, niche banks that can cause externalities not only to a particular bank but also to the entire financial systems and the economy. While complex financial groups pose increasing risks to financial stability as they grow and become embedded in the financial system, specialised banks can cause equal hazard and stall innovation and risk-taking behaviour.

To function effectively, a resolution regime must achieve certain economic objectives, that is, reduce 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. The trust of depositors is fundamental to any banking resolution system.

As mentioned above, the current insured limit for depositors in India does not gain much confidence among the depositors. The proposed bail-in provision covering uninsured deposits will leave the latter exposed to losses. However, there are wider implications of a significant increase in deposit insurance coverage as it will increase the cost of bank products and services and may result in other risks. It will raise the demand for deposits, leading to a decline in deposit interest rates and an increase in bank reliance on deposit funding. A related issue is the funding of such insurance schemes. Who shall bear the cost? It also may give rise to perverse incentives for banks to rely more on deposits than credit, which will be fundamentally antagonistic to their risk-taking behavior, dampening the moral hazard concerns.

<sup>124</sup>Ibid., Section 48.

<sup>125</sup>Ibid., Section 62.

<sup>126</sup>Idem.

Uninsured depositors, many of the companies with significant financial resources and market presence must assume responsibility for selecting their bank and they should not count on government bailouts to avoid losses in case of bank failures. On this matter, a wide-ranging dialogue between the Indian government and businesses, and society must take place to determine the acceptable limit of insurance protection as it is clear that the current limit is not acceptable.

For insured deposits, the depositors must be paid quickly to ensure minimal economic disruption and to help restore the overall public trust in the Indian banking system. Access to bank accounts must also be restored swiftly. The banking resolution framework that is designed must ensure this, an important aspect on which FRDI Bill is silent. In the UK, Singapore, Australia and many other jurisdictions, regulations to enable fast pay-out to depositors and quick access to accounts, within a period of 7 days.

## 4 | THE POST-GFC BANK CRISIS MANAGEMENT AND RESOLUTION FRAMEWORK OF THE EU

In order to understand the impact of the March 2023 turmoil on the EU crisis management, resolution and deposit insurance legal framework, it is important to outline the current EU regulatory and supervisory architecture. The EU is an incomplete union of Member States, which results in the EU sharing with its Members responsibility for implementing the agreed rules. For any proposed new legislation, the EU has to enter into complex negotiations with its Member States about the scope and content of the new legislation and the allocation of work between EU bodies and national authorities. EU laws typically target both improvements to the substantive rules and the strengthening of the union by either reinforcing the role and power of EU bodies or streamlining the relationship with Member States.

### 4.1 | The post-GFC EU reforms

The post-EU reforms on bank resolution were part of a much larger package whose aim was to create a single rulebook for banks in the EU and to centralise bank supervision.

The absence of EU-level supervisory bodies was rectified with the establishment in 2010 of the European System of Financial Supervision (ESFS), which included three new European supervisory authorities (ESAs): the [European Banking Authority \(EBA\)](#), the [European Securities and Markets Authority \(ESMA\)](#), and the [European Insurance and Occupational Pensions Authority \(EIOPA\)](#). The new authorities were granted powers to set out regulatory standards and coordinate their implementation at national level. However, these powers were not absolute.<sup>127</sup> Day-to-day supervision has remained a responsibility of national authorities although the latter's discretion and powers to act autonomously have been significantly reduced by the new EU authorities.<sup>128</sup> The [European Systemic Risk Board \(ESRB\)](#) was added as a new body with responsibility to monitor systemic risks. For large cross-border banks, the decision was made to strengthen the colleges of supervisors, which would assume the supervisory responsibility.<sup>129</sup>

<sup>127</sup>Christos Gortsos and Katerina Lagaria, 'The European Supervisory Authorities (ESAs) as "direct" supervisors in the EU financial system' (EBI Working Paper Series 2020 No. 57), 3–5.

<sup>128</sup>See also Iris Chiu and Joanna Wilson, *Banking Law and Regulation* (OUP, 2019), 290.

<sup>129</sup>Ibid., 43.

Core elements of the single rulebook<sup>130</sup> are the legislative package on bank recovery and resolution. The EU passed legislation aimed to harmonise capital requirements for banks and to implement Basel III,<sup>131</sup> and new rules about deposit guarantee schemes (DGSs) aimed to address diverging national approaches to deposit insurance.

To address the absence of EU-level supervision and coordination, the EU created the Single Supervisory Mechanism (SSM)<sup>132</sup> overseen by the European Central Bank (ECB) aimed to provide unified, EU-level prudential supervision of banks and the Single Resolution Mechanism (SRM),<sup>133</sup> comprising a Single Resolution Board, a common resolution fund, aimed to establish a common framework and financing mechanism for dealing with bank failures.<sup>134</sup>

SSM and SRM formed the two pillars of the Banking Union,<sup>135</sup> a mechanism created in 2014 to handle centrally the regulation, supervision and resolution of banks of the eurozone and of any other EU country not a member of the eurozone wishing to join. With these steps, the EU, which, in 2010–2012, had suffered also from a sovereign debt crisis,<sup>136</sup> which had placed significant new strains on the Union's banking system, hopes to safeguard the stability of its financial system and to prevent new crises.

## 4.2 | Key elements of the EU bank recovery, resolution and deposit insurance reforms

The EU reforms followed the FSB's Key Attributes and aimed to establish clear and effective processes for dealing with distressed banks without causing market disruption or contagion, while avoiding bank bailouts and safeguarding depositors. The EU legal framework for the recovery and resolution of credit institutions and investment firms includes an extensive package of laws, the central pieces of which are the Bank Recovery and Resolution Directive

<sup>130</sup>See <<https://www.eba.europa.eu/regulation-and-policy/single-rulebook>>.

<sup>131</sup>Idem.

<sup>132</sup>See <<https://www.consilium.europa.eu/en/policies/banking-union/pillar-i-the-single-supervisory-mechanism/>>.

<sup>133</sup>Idem.

<sup>134</sup>Christos Gortsos, 'The Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF): Legal Aspects of the Second Main Pillar of the (European) Banking Union, fifth Edition' (30 April 2019), 37, available at: <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2668653](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2668653)>.

<sup>135</sup>See <<https://www.consilium.europa.eu/en/policies/banking-union/>>.

<sup>136</sup>The sovereign debt crisis emerged as a result of the high bank bailout costs and the costs of fiscal measures, which EU Member States passed to support their economies during the economic downturn that followed the GFC. The measures raised the debt levels of EU national governments from around 60% of GDP before the crisis to 87% in 2014: Marcin Szczepanski and Eulalia Claros, 'A Decade on from the Financial Crisis: Key Data' (European Parliamentary Research Service, Briefing PE 640.145, October 2019), available at <[https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/640145/EPRS\\_BRI\(2019\)640145\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/640145/EPRS_BRI(2019)640145_EN.pdf)>. Some EU countries saw levels of debt well above 100% of their GDP generating a new crisis. During 2010–2011, Greece, Portugal and Ireland received IMF bailouts, while Greece also received EU loans: Christos Hadjiemmanuil, 'Bank Resolution Financing in the Banking Union' (LSE Law, Society and Economy Working Papers 6/2015), available at <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2575372](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575372)>. In 2012, Spain requested EU financial support as a result of the Spanish government's efforts to deal with the collapse of the large bank Bankia and to support the Spanish banking sector. Finally in June 2012, Cyprus, whose banks suffered significant losses from the restructuring of the Greek sovereign debt, requested EU bailout. The sovereign debt crisis led to new problems for the financial sector as commercial banks had significant exposure to sovereign debts and accelerated the process for the creation of the Banking Union.

(BRRD),<sup>137</sup> which was adopted in 2014 (Directive 2014/59/EU), and the Single Resolution Mechanism Regulation 806/2014 (SRMR),<sup>138</sup> which was adopted in 2014.

The Directive was amended in 2019 by Directive 2019/879,<sup>139</sup> often referred to as BRRD II as regards the loss-absorbing and recapitalisation capacity and, in 2022, by the ‘Daisy Chain’ Regulation 2022/2036,<sup>140</sup> which introduced targeted adjustments aimed at improving the resolvability of banks. SRMR<sup>141</sup> was amended in 2019.<sup>142</sup>

The EU addressed the issue of the resolution of EU-wide SIBs or banks with significant cross-border activity with the creation of a new EU resolution authority, the Single Resolution Board (SRB).<sup>143</sup> SRB develops with regulators, the ECB and individual banks the resolution plans, which contain responses to various negative scenarios for the banks. SRB handles itself the resolution of entities and groups directly supervised by the ECB and cross-border groups. The remaining banks are currently dealt with by national authorities domestically. ECB plays a central role in the SSM, as the most important EU bank supervisor.

The EU DGSS, funded entirely by the banking industry, aim to address the risk of bank runs by retail depositors by offering deposit protection up to EUR 100,000 per account across the Union. They also contribute to financial stability by acting as buffer mechanisms in periods of financial crisis.<sup>144</sup> An additional important function of DGSS is to contribute as complementary financing source beyond depositors’ pay-outs to the resolution of banks.<sup>145</sup> In EU, as in India, the US and other jurisdictions, DGSS do not guarantee all deposits. Uninsured deposits (those exceeding EUR 100,000) can still expose banks to the risk of failure, but regulators have determined that such an exposure is necessary to prevent the rise of moral hazard and impose discipline on banks.<sup>146</sup> A significant weakness of the EU guarantee scheme is its fragmented nature, as DGSS are funded and managed at the national level. Wealthy EU countries, especially Germany, opposed the mutualization of deposit insurance through a European scheme fearing that they would have to use their own funds for depositor pay-outs in poorer EU countries.<sup>147</sup>

To support the implementation of resolution when banks’ own recourses and the use of bail-in are not sufficient,<sup>148</sup> the EU created a Single Resolution Fund (SRF), an industry-funded complementary financing mechanism. Banks are the sole contributors to SRF, which from 2022

<sup>137</sup>Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance.

<sup>138</sup>See <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0806>>.

<sup>139</sup>See <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019L0879>>.

<sup>140</sup>See <<https://eur-lex.europa.eu/eli/reg/2022/2036/oj>>.

<sup>141</sup>Above note 138.

<sup>142</sup>See <<https://www.cssf.lu/en/resolution/>>.

<sup>143</sup>Article 1, SRMR.

<sup>144</sup>Christos Gortsos, ‘Deposit Guarantee Schemes: General Aspects and Recent Institutional and Regulatory Developments at International and EU Level’ (2016), 3, available at <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2758635](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2758635)>.

<sup>145</sup>Ibid., 5.

<sup>146</sup>See Jonathan Rose, ‘Old-Fashioned Deposit Runs’ (Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2015–111), 5, available at <<https://doi.org/10.17016/FEDS.2015.111>>.

<sup>147</sup>Mariana Mortágua and Izaura Solipa, ‘Reviving financial markets – a critical assessment of the single resolution mechanism’ (2022) 36(3) *International Review of Applied Economics* 403–423; Gortsos (above note 144), 138.

<sup>148</sup>Article 67, SRMR.

onwards is reinforced by a backstop fund to be used in emergencies and which is financed through public financing.<sup>149</sup> SRF is owned by SRB.

### 4.3 | The crisis management and resolution process

Crisis prevention measures constitute the first step in the EU framework and include the submission by banks of recovery plans to the relevant competent authority. The plans include corrective actions that the banks will take to restore viability in conditions of deteriorating financial situation.<sup>150</sup> The plans are updated annually or when there are material changes in the situation of the banks and must not assume access to public funds. They must include details about when and how the banks will use central bank facilities and must identify the qualified assets that will be used as collateral.<sup>151</sup>

Recovery plans aim to address scenarios of bank distress from a wide range of causes including bank's own activities and wider market or economic crises and take into account also the impact of the plans on other banks.<sup>152</sup>

The recovery plans can help prevent bank failures, but they do not offer full prevention. Banks can still fail, and for such a scenario or the near failure of a bank, the relevant resolution authorities, SRB or national authorities,<sup>153</sup> must draw up *ex ante* resolution plans containing the resolution strategy. The strategy is selected following a thorough analysis of the bank's legal, financial and operational structures and other critical elements.<sup>154</sup> Resolution plans take into account scenarios of individual banks or wider market distress and assume no extraordinary public financial support besides the standard resolution financing arrangements,<sup>155</sup> any central bank emergency liquidity assistance and any central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms.<sup>156</sup> Resolution plans are very thorough and include the resolution tools<sup>157</sup> that will be used in each potential scenario and operational information.

A central element of resolution plans is the assessment of the bank's resolvability without assuming extraordinary public financial support or central bank liquidity support.<sup>158</sup> A bank is 'resolvable' if it is 'feasible' and 'credible' for the resolution authority,

'...to either liquidate it under normal insolvency proceedings or to resolve it by applying the different resolution tools and powers avoiding wider market instability'.<sup>159</sup>

<sup>149</sup>See Single Resolution Fund, available at <<https://www.srb.europa.eu/en/content/single-resolution-fund>>.

<sup>150</sup>European Banking Authority, 'Guidelines on recovery plan indicators under Article 9 of Directive 2014/59/EU' (9 November 2021) (EBA/GL/2021/11), available at <<https://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/guidelines-on-recovery-plans-indicators>>.

<sup>151</sup>Article 5(4), BRRD.

<sup>152</sup>*Ibid.*, Articles 5(6) and 7(4).

<sup>153</sup>Single Resolution Board, 'Expectations for Banks' (March 2020), available at <[https://www.srb.europa.eu/system/files/media/document/efb\\_main\\_doc\\_final\\_web\\_0\\_0.pdf](https://www.srb.europa.eu/system/files/media/document/efb_main_doc_final_web_0_0.pdf)>.

<sup>154</sup>*Idem.* See also Article 8(12), SRMR.

<sup>155</sup>Articles 100–104, BRRD. Such arrangement includes the creation of resolution funds, raised through industry contributions, which can be used for the purpose of financing bank resolutions.

<sup>156</sup>*Ibid.*, Article 10(3).

<sup>157</sup>See below.

<sup>158</sup>Article 15(1), BRRD.

<sup>159</sup>*Idem.*



The triggering of the resolution process may be avoided through early intervention by regulators (ECB or national regulators). Early intervention can be initiated after the occurrence of events such as the rapidly deteriorating financial condition of the bank, including deteriorating liquidity situation, increasing level of leverage, rising non-performing loans or concentration of exposures.<sup>160</sup> The deterioration may not have yet reached the regulatory thresholds that would trigger the resolution process, but there may be a realistic scenario pointing to such a potential in the near future.

Early intervention action depends on the individual circumstances of the bank and the cause of the emerging problem. Regulators may require implementation of measures listed in the recovery plan, may request from the bank management to draw up plans to overcome the problem within a specific timeframe, convene a meeting of shareholders and request the removal or replacement of members of the bank board identified as responsible for the problem, and other measures.<sup>161</sup>

The resolution stage is triggered for large banks by the SRB and for all other banks by national resolution authorities,<sup>162</sup> but the exercise of this power is subject to three strict legal conditions that must all be met:

- a. the bank ‘is failing or is likely to fail’;
- b. there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe; and
- c. a resolution action is necessary in the public interest.

If the bank needs extraordinary public support, EU law establishes an additional option, which is known as ‘precautionary recapitalisation’ and which could be provided without triggering the bank resolution process and can be used only if one of the other triggers of bank failure above is not in existence; otherwise, the bank will enter the resolution process. Precautionary recapitalisation may be used for example where the bank has failed stress tests.<sup>163</sup> Precautionary recapitalisation is subject to a number of conditions.<sup>164</sup>

The objectives of resolution stage are the following<sup>165</sup>:

- a. to ensure the continuity of bank critical functions;
- b. to avoid significant adverse effects on financial stability, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline;
- c. to protect public funds by minimising reliance on extraordinary public financial support;
- d. to protect depositors and investors; and
- e. to protect client funds and client assets.

EU authorities also aim to minimise the cost of resolution and avoid the unnecessary destruction of value.

The main principles governing bank resolution, which reflect the FSB’s Key Attributes, include the following<sup>166</sup>: the shareholders of the bank will bear first losses, followed by the

<sup>160</sup>Ibid., Article 27.

<sup>161</sup>Idem.

<sup>162</sup>Ibid., Article 32(1).

<sup>163</sup>Chiu and Wilson (above note 128), 638.

<sup>164</sup>Article 32(4)(d), BRRD.

<sup>165</sup>Article 14, SRMR.

<sup>166</sup>Ibid., Article 15(1).

bank's creditors, who will bear losses in accordance with the order of the priority of their claims; creditors of the same class are treated in an equitable manner; creditors will not incur greater losses than they would have been incurred if the entity had been wound up under normal insolvency proceedings<sup>167</sup>; the management body and senior management of the bank will be replaced unless their retention is considered to be necessary for the achievement of the resolution objectives<sup>168</sup>; the management body and senior management of the bank under resolution shall provide all necessary assistance for the achievement of the resolution objectives; natural and legal persons will be made liable, subject to national law, under civil or criminal law, for their responsibility for the failure of the institution under resolution; and covered deposits will be fully protected.<sup>169</sup>

The traditional resolution tools available under EU law include the sale of business tool,<sup>170</sup> the bridge institution tool,<sup>171</sup> and the asset separation tool.<sup>172</sup> Before the GFC, public funds and bank nationalisation (temporary or permanent) were used to finance the resolution scheme. However, the spiralling costs for taxpayers of the bank bailouts during the GFC helped to build an international consensus in favour of private contributions to the resolution of the banks. This took the form of a fourth tool that of bail-in. The resolution tools can be used either individually or in any combination, but the asset separation tool can be used only together with another resolution tool.

Bail-in aims to allocate to the private sector, primarily the bank shareholders and a range of junior and unsecured creditors,<sup>173</sup> a share of the cost of bank failures and recovery. Banks can use the tool voluntarily when they face capital adequacy issues or the tool could be imposed on them by the regulators either as a resolution tool (alone or in combination with other resolution tools) or outside of resolution such as when a bank has failed a stress test.<sup>174</sup>

In the case of regulatory intervention, the consent of affected creditors and shareholders is not required. The process involves the writing down of certain types of debt obligations or their converting into equity. Insured deposit liabilities are normally excluded along with secured liabilities and liabilities to other institutions. The bank shareholders and unsecured creditors including unsecured depositors assume the main burden, although forcing losses on uninsured depositors has been relatively rare.

The bail-in process in EU law as it stands sacrifices the shareholders first, by cancelling or diluting their capital to help recapitalise the bank.<sup>175</sup>

## 5 | REGULATORY PERSPECTIVES FROM INDIA AND EU POST-SVB AND CREDIT SUISSE

Between 2008 and 2013 in the aftermath of GFC, more than 500 banks, most of them small- and medium-sized banks, failed in the USA alone.<sup>176</sup> However, since GFC, the focus of

<sup>167</sup>Idem.

<sup>168</sup>Above note 159.

<sup>169</sup>Idem.

<sup>170</sup>Article 38(1), BRRD.

<sup>171</sup>Ibid., Article 39.

<sup>172</sup>Ibid., Article 42.

<sup>173</sup>Chiu and Wilson (above note 128), 642.

<sup>174</sup>Idem.

<sup>175</sup>Above note 171.

<sup>176</sup>FDIC History (above note 57), xiii.

regulators, due to the cost of bailouts during the crisis, had shifted to the very large banks, whose failure, due to their size, interlinks and involvement in critical functions of the financial system, had increased probability of leading to a systemic crisis. Failures of smaller banks had been presumed to be of low risk. The bank failures of March 2023 challenged this thinking. The crisis did not engulf any of the eight systemically important US banks. Instead, some of the big banks benefitted from deposit inflows during the crisis as depositors saw them as islands of stability.<sup>177</sup>

On the other hand, SVB, Signature and First Republic Banks and other affected banks were all medium-sized banks, with limited connections with the rest of the industry, and were not involved in critical functions of the financial system.<sup>178</sup> Still, their failures generated a market contagion, which forced public intervention to contain it. The March 2023 crisis proved that, in appropriate circumstances, which in the case of SVB included a combination of a high concentration of uninsured corporate depositors with significant deposits, the use of social media to rapidly spread rumours about the bank troubles and mobilise depositors, and the use of technology to request immediate withdrawals,<sup>179</sup> a failure of a medium-size bank could shake confidence in the wider banking system in the same way as a failure of a much larger SIB. Financial market instability is even more likely to emerge when the wider economic environment, in this case fast rising interest rates, high inflation and economic slowdown, can act as facilitator of bank failures and financial crises. A key lesson from the crisis in this area is that regulators should widen their focus when seeking to identify and prevent risks of wider financial market instability.

Furthermore, the case of Credit Suisse was not technically one of the bank failures, as the resolution framework was not used, even if it was a SIB. However, the takeover of Credit Suisse by UBS had all the characteristics of a classic bank rescue, as a result of public intervention that involved state guarantees,<sup>180</sup> such as those that the banking sector experienced during GFC. However, what was new was that Credit Suisse was the first SIB to fail after the adoption of post-GFC reforms and the first where the resolution framework was not used.

The failure of the three US banks and of Credit Suisse have not caused a market crisis in India or the European Union, but the events of March 2023 raise some issues, which have been debated in the two jurisdictions as well. The next sections discuss these issues.

## 5.1 | Perspectives from India

India has high share of uninsured deposits. While the increase in deposit cover led to increase in percentage of protected accounts to total accounts from 91% to 98%, it also led to increase in banks' liabilities from 28% to 51% in the same period.<sup>181</sup> This means the uninsured deposits in India are at 49%, levels similar as the USA.<sup>182</sup> Furthermore, India's deposit insurance scheme

<sup>177</sup>Financial Stability Report (above note 1).

<sup>178</sup>Michael Barr (Vice Chair for Supervision of the Board of Governors of the Federal Reserve System), 'Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank' (28 April 2023), 2, available at <<https://www.federalreserve.gov/publications/review-of-the-federal-reserves-supervision-and-regulation-of-silicon-valley-bank.htm>>.

<sup>179</sup>Idem.

<sup>180</sup>See also Erik Thedéen, 'The links between monetary policy, financial stability and fiscal policy' (Speech to the Swedish Economic Association, Stockholm, 23 May 2023), available at <<https://www.bis.org/review/r230524c.pdf>>.

<sup>181</sup>Idem.

<sup>182</sup>Above note 174.

does not follow a risk-based premium system, which means higher risk institutions pay higher premiums. Instead, all participating institutions pay the same premium in the Indian system. It covers various types of banks including commercial banks, regional rural banks (RRBs), local area banks and cooperative banks. Cooperatives and smaller rural banks are riskier. Given that the bank transactions are increasingly happening via digital prepaid instruments (PPI), another pertinent question that arises is whether such instruments are covered under deposit insurance scheme and more importantly, whether the cover insulates the depositors from the risking case of bank failure. While the answer to the former is affirmative, the risk coverage certainly does not insulate the depositors as the insured sum is only INR 5 lakh (approximately USD 6,000). Thus, although the deposit insurance scheme covers all the commercial accounts, there is a concern regarding the small cooperative banks as most of these banks sit uncomfortably in the heterogeneous banking structure.<sup>183</sup>

Also, in the proposed FRDI Bill, big banks continue to gain all the attention, the cooperative banks that play a significant role in credit delivery to the rural population and contribute to financial inclusion remain confined in an unglamorous state. There are 1,531 UCBs and 97,006 rural cooperative banks, with the latter making up 65% of the total asset size of all cooperatives taken together. Despite the crucial role played by the cooperative sector, its asset size was only around 10%, compared to that of scheduled commercial banks (SCBs) at end of March 2020.<sup>184</sup> At present, the cooperative banks too are covered by the DICGC. While there is a separate debate on the role of DICGC under the FRDI Bill, a more pertinent issue is how will the proposed framework address the challenges in the cooperative and other rural banks.

As far as uninsured depositors are concerned, collateralisation of large uninsured deposits may consider an option to limit bank reliance on uninsured deposits, reduce depositor run incentives and increase depositor discipline.<sup>185</sup> There could be limited, targeted or unlimited coverage for the deposit accounts. The RBI could develop a matrix to achieve this. Limited Coverage maintains the current system of deposit insurance and does not, by itself, address the run risk associated with high concentrations of uninsured deposits, even with an increase to the deposit insurance limit. Targeted coverage would provide substantial additional coverage to business payment accounts without extending similar insurance to all deposits, yielding large financial stability benefits relative to its costs. A challenge to targeted coverage is the need to delineate between business payment deposits and other deposits. Unlimited coverage—fully insuring all deposits—effectively removes run risks but may have large effects on bank risk-taking, the level of deposit insurance assessments on banks and broader financial markets.

In the times of growing technology and social media penetration, information sharing has become faster and scalable. At the click of a button, information can be shared with thousands or millions of people. In parallel, technological advances in the financial sector allow for large financial transactions to occur with unprecedented ease. Depositors can easily set in motion the transfer monies and move funds across asset class with much ease. These changes allow depositors to monitor their banks more easily, potentially increasing the effectiveness of depositor discipline and exacerbating the potential for panic-driven runs. Thus, banking crisis must be tackled with great efficiency and sensitivity.

<sup>183</sup>See <<https://www.newindianexpress.com/business/2021/aug/22/cooperative-banks-continue-to-be-a-sore-for-indias-banking-sector-2347982.html>>.

<sup>184</sup>Idem.

<sup>185</sup>For further discussion, see <<https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf>>.

## 5.2 | Perspectives from EU: The EU April 2023 reform package

In April 2023, the European Commission published a package of proposals for the reform of the Union's bank crisis management and deposit insurance framework (CMDI),<sup>186</sup> which had been established after the GFC.

The Commission's aim is to address perceived weaknesses in the existing framework.<sup>187</sup> Although the events of March 2023 were not the sole cause of the Commission's initiative, they did exert a significant influence on the content of the proposals, many of which incorporated the lessons from this crisis. There was a recognition in the EU that Union law had to be better prepared to deal with financial crises originating from outside the large, SIBs and that the deposit insurance arrangements had to be expanded and improved. Although the March 2023 events did not directly raise the issue of the use of resolution or insolvency as the best mechanism for dealing with failures of smaller banks, they did highlight the significance of an effective mechanism of crisis prevention, which includes swift action for bank resolution, a clear and readily available resolution financing mechanism, which would not include the use of public funds and a well-funded deposit insurance system. The US proved effective in this front as the systemic risk exception allowed FDIC the flexibility to intervene in the failure of medium-sized banks and to move swiftly to resolve SVB and Signature using industry funds. Depositors in the USA are insured for deposits of up to USD 250,000,<sup>188</sup> which is significantly higher than EUR 100,000 in the EU.

For the EU, the resolution/insolvency issue is directly related to the above areas. Most banks of the Union are still sent to Member States, which apply a variety of insolvency regimes<sup>189</sup> and where liquidation aid by the states is often used to support the sale of the failing banks.<sup>190</sup> The continuing use of bailouts, which frustrates the decision adopted post-GFC to eliminate the practice of using taxpayer funds to finance bank rescues, is partly caused by the highly inflexible and restrictive framework adopted in the EU post-GFC, which excludes from resolution and the funds associated with it, small- and medium-size banks. These banks are not deemed systemically significant at the EU level, as the public interest test used to determine whether resolution will be used is restrictive and hard for such banks to meet. These banks are dealt with at national level through insolvency rules that are not harmonised. National insolvency rules provide a range of options including liquidation state aid.<sup>191</sup> Uninsured depositors are also treated differently across EU countries, some of which have introduced a general depositors' (insured and uninsured) senior preference over other preference creditors

<sup>186</sup>The documents of the reform package can be found at <[https://finance.ec.europa.eu/publications/reform-bank-crisis-management-and-deposit-insurance-framework\\_en](https://finance.ec.europa.eu/publications/reform-bank-crisis-management-and-deposit-insurance-framework_en)>.

<sup>187</sup>European Commission, 'Banking Union: Commission proposes reform of bank crisis management and deposit insurance framework' (Press Release, 18 April 2023), available at <[https://ec.europa.eu/commission/presscorner/detail/en/ip\\_23\\_2250](https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2250)>.

<sup>188</sup>See <<https://www.fdic.gov/resources/deposit-insurance/faq/#:~:text=The%20FDIC%20insures%20deposits%20according,insured%20bank%2C%20per%20ownership%20category>>.

<sup>189</sup>See European Commission Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency {SWD(2023) 225–226 final} - {SEC(2023) 230 final}, 4.

<sup>190</sup>Fernando Restoy, Rastko Vrbaski and Ruth Walters, 'Bank failure management in the European banking union: What's wrong and how to fix it' (FSI Occasional Paper No. 15, 2020), 11, available at <<https://www.bis.org/fsi/fsipapers15.pdf>>.

<sup>191</sup>Idem. For a discussion see Baudino et al. (above note 50), 47.

(e.g., bondholders), while other countries offer preference to insured depositors over uninsured ones.<sup>192</sup> Processes for handling insolvency are also different.

National authorities also seem to be diverging from SRB guidance in the interpretation and application of ‘public interest’ when they assess action for failing banks.<sup>193</sup> The cooperation of SRB with national authorities, which have to work together in the implementation of the framework also often exhibits signs of strain undermining the effectiveness of the overall framework.<sup>194</sup> The existing regulatory gaps and fragmentation could hinder the ability of the EU and Member States to move fast to stop rapidly growing contagion risks from escalating into systemic crisis events in cases such as SVB. The market turmoil of March 2023 made urgent need for the EU to address these weaknesses and, especially, the absence of resolution options for small- and medium-sized banks.

The Commission’s April 2023 reforms aim to address the above identified issues: they include proposals for amending the provisions about the scope and triggers of resolution for the purpose of establishing a clear preference to resolution over insolvency; reinforcing the emphasis to the use of industry resources rather than public funds to fund resolution; and offering expansive protection of depositors and expansive use of DGS in resolution under strict conditions and safeguards.

To achieve these aims on the scope and triggers of resolution the Commission proposes<sup>195</sup>: clarifying in the law that insolvency will be selected ‘...only when they achieve the framework’s objectives better than resolution’ and not to the same extent as stated before; the addition of ‘national or regional level’ to the definition of ‘critical functions’ of banks, which are included in the current objectives of resolution with the purpose of granting a wider perspective in the relevant objective; the addition of an explicit reference to a preference for funding by industry-funded safety nets over the use of public funds<sup>196</sup>; and the change of public interest assessment procedures to include consideration and comparison of the cost for public funds from resolution and insolvency and the clear preference to resolution if insolvency will include liquidation aid.<sup>197</sup> Resolution will also be preferred, if insolvency will be more costly to DGSs.<sup>198</sup>

The clarification and harmonisation of public interest assessment had also been requested by the EU Parliament<sup>199</sup> and the Eurogroup<sup>200</sup> to ensure consistency and predictability of the use of SRM framework.

<sup>192</sup>See also G. Edwards and N. Charney, ‘How The EU’s Bank Crisis Management Reforms Could Affect Ratings’ (25 April 2023), available at <<https://www.spglobal.com/ratings/en/research/articles/230425-how-the-eu-s-bank-crisis-management-reforms-could-affect-ratings-12711278>>; Fernando Restoy, ‘How to improve crisis management in the banking union: a European FDIC?’ (4 July 2019), available at <<https://www.bis.org/speeches/sp190715.pdf>>; Baudino et al. (above note 50), 47.

<sup>193</sup>See also Elke König, ‘To resolve or not to resolve: a public interest assessment fit for purpose’ (2020), available at <<https://www.srb.europa.eu/en/content/resolve-or-not-resolve-public-interest-assessment-fit-purpose>>.

<sup>194</sup>Idem.

<sup>195</sup>Commission Proposal amending Directive 2014/49/EU, 14.

<sup>196</sup>Idem.

<sup>197</sup>Idem. For a discussion, see also Fernando Restoy, ‘The quest for deposit stability’ (Speech to the EFDI International Conference, Budapest, Hungary, 25 May 2023), available at <<https://www.bis.org/speeches/sp230525.htm>>.

<sup>198</sup>Idem.

<sup>199</sup>European Parliament, Banking Union – Annual Report 2021, European Parliament resolution of 5 July 2022 (2021/2184(INI)) paragraph 29.

<sup>200</sup>Eurogroup statement on the future of the Banking Union of 16 June 2022, available at <<https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/>>.

The case of SVB raised the issue of better protection in some cases of uninsured deposits when internal loss-absorbing capacity of the bank is insufficient to seal them from losses. To avoid imposing losses on these depositors, the Commission proposes,<sup>201</sup> subject to conditions and safeguards, the use of DGS funds to access resolution funds. Under the current rules, access to funds of SRF is restricted by the requirement that they can be accessed only after a creditors' bail-in amounting to a minimum of 8% of bank's total liabilities.<sup>202</sup> And this applies to all banks. Additionally, the current rules require all banks to issue an amount of bail-in-able securities specific to them. The Commission has admitted it in its reform proposals that some small- and medium-sized EU banks face challenges meeting these requirements without having to impose losses on their depositors,<sup>203</sup> and as a result, they are either excluded from resolution funds or they have to impose losses on the depositors, which, in some cases, could endanger financial stability. Overall, the combination of a strict public interest test with the 8% bail-in requirement makes access to resolution and public funds prohibitive for many medium-size banks.<sup>204</sup>

The Commission now proposes to use DGS funds to bridge the gap when banks cannot meet the 8% threshold. Also, to enable the better use of DGS funds in resolution, the Commission proposes the removal of an important barrier to the use of such funds, which is the 'super-preferential status' of DGS funds in the current three-tier hierarchy of depositor claims in insolvency.<sup>205</sup> Insured deposits and DGS claim currently sit on the top tier and enjoy preference over uninsured deposits held by households and small businesses and those held by corporations. The Commission proposes the creation of a single tier will include all deposits (insured, uninsured and DGS claims), which will now receive preferential status over other unsecured claims such as bonds.<sup>206</sup> The proposal brings the EU framework close to the US one where uninsured deposits enjoy same status in the hierarchy of claims as the insured ones. However, the US coverage of deposit is significantly higher than that of the EU and currently stands at USD 250,000. The Commission's proposals do not include an increase in the amount of deposit coverage. Instead, they extend the scope of insurance protection to certain deposits linked to public authorities and client funds and offer coverage for a short period to temporary high balances as a result of specific life events (e.g., inheritance).<sup>207</sup>

Also, the use of DGS funds is subject to a 'least-cost test', which allows DGS funds to be used in resolution only if the cost of that use does not exceed the cost of the use of those funds to reimburse insured depositors in case of liquidation. A similar approach exists in the USA, but the latter offers additional flexibility. For example, in the March 2023 US bank failures, all deposits (covered and uncovered) were transferred from the failed banks to a suitable acquirer. US law allows for waiving the least-cost test when there is a risk to financial stability.<sup>208</sup>

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<sup>201</sup>European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2014/59/EU as regards early intervention measures, conditions for resolution and financing of resolution action, Strasbourg, 18.4.2023 COM(2023) 227 final, 2023/0112 (COD) ('EC Reform Proposals'), 15.

<sup>202</sup>Article 109(2)(b), BRRD.

<sup>203</sup>Above note 201.

<sup>204</sup>For a discussion, see Restoy (above note 197).

<sup>205</sup>EC Reform Proposals (above note 201), 17.

<sup>206</sup>Idem.

<sup>207</sup>European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency [SWD(2023) 225–226 final] - [SEC(2023) 230 final].

<sup>208</sup>See also Restoy (above note 197).

The expansive use of industry-funded DGSs in resolution will likely require an increase in the bank contribution to the funds. The Commission had been careful to avoid raising the cost of bank contributions and has maintained the current ceiling of EUR 100,000 per account, which has not been inflation-adjusted since the post-GFC reforms. However, as banks are required to replenish the DGS funds if they suffer losses, the increased potential of increased DGS losses under the proposed regime will also increase banks' contribution to the scheme. The current target of level DGS funds varies across Member States, but the EU requires funds sufficient to cover at least 0.8% of covered deposits.<sup>209</sup>

In an effort to further reduce the use of public funds in bank resolution, the reforms target also the precautionary recapitalisation of banks, which takes place outside of resolution and sometimes involves the use of public funds. The reforms propose stricter conditions for precautionary recapitalisations, with new provisions requiring that the relevant measures must be temporary and be available only to solvent institutions not institutions with outdated business model. The reforms also propose the reduced use of perpetual instruments such as Common Equity Tier 1, which should be used only exceptionally in the absence of alternative forms of capital instruments.<sup>210</sup>

Overall, the Commission's proposals offer better overall protection of depositors (insured and uninsured) in both resolution and liquidation, but they also harmonise the relevant rules at national level where currently Member States often follow their own laws and practices in regard to the use of insolvency/resolution options or the management of claims in resolution and insolvency frustrating EU's effort for legal harmonisation.

## 6 | CONCLUSIONS: THE WAY FORWARD

Even before the market turmoil of March 2023, it had become clear that the existing crisis management and resolution framework for banks, which has been enacted internationally after GFC and incorporated the lessons from that crisis, had certain weaknesses, which had to be addressed. The market turmoil of March 2023 provided the evidence and the urgency needed for regulators to proceed to action in this direction.

First, the GFC reforms did not resolve the problem of uninsured deposits, which remained a ticking bomb in the foundations of the financial system. This was a calculated risk that regulators had taken when they decided to offer only limited deposit insurance cover targeting specifically retail depositors. However, more recently, it had become clearer that a review of the post-GFC arrangement was needed. Forcing losses on uninsured depositors, even if these are corporations, has never been politically easy and the potential ripple effect on the economy in case of corporate insolvencies as a result of these losses can never easily be ignored. The statement of British Finance Minister Jeremy Hunt who was involved in the negotiations for the rescue of SVB's UK subsidiary<sup>211</sup> is indicative:

<sup>209</sup>European Banking Authority Deposit Guarantee Schemes data, available at <<https://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data#:~:text=In%20most%20instances%2C%20the%20target,have%20a%20higher%20target%20level>>.

<sup>210</sup>EC Reform Proposals (above note 201), 19.

<sup>211</sup>SVB'S UK subsidiary was acquired for GBP 1 on 13 March 2023.



'We were faced with a situation where we could have seen some of our most important companies - our most strategic companies - wiped out, and that would have been extremely dangerous'.<sup>212</sup>

Statements like this and reactions such as those of US regulators in the US who invoke systemic risk exception to protect also uninsured deposits during the March 2023 turmoil provide clear evidence that the existing deposit insurance system may need improvements to offer better depositors' protection.

On the other hand, completely eliminating deposit risk by insuring all deposits or guaranteeing their transfer from the failed bank to a suitable acquirer in periods of crisis would generate moral hazard for both banks and depositors. Banks would relax their risk management focus, leading to more bank failures, whereas depositors will be less careful when selecting the bank for their deposits, resulting in them banking with banks operating weak business models and ineffective risk management policies. The overall effect will be that reckless bank and depositor behaviour would end up being paid for by the industry through the use of deposit insurance or public funds offering backstop or bailouts. The cost of banking for all bank customers will then increase as the industry will seek to pass the additional insurance costs to consumers.

A median solution, which appears to be favoured by FDIC in the USA, is the option of targeted coverage, which proposes establishing different deposit insurance coverage (ranging from unlimited coverage to limited coverage) across various account types.<sup>213</sup> Under the proposal, higher coverage could be offered to payment accounts that are used by households and businesses to pay their bills and lower coverage to investment accounts. Such a solution could minimise disruption to the economy from bank failures, but the approach also faces challenges as companies may find ways to circumvent the policy and moral hazard could still increase. Still, this approach can be part of a debate along with other scenarios including that of unlimited coverage.

In India, all commercial banks including branches of foreign banks, local area banks and RRBs are insured by the Deposit Insurance and Credit Guarantee Corporation.<sup>214</sup> While this policy appears good for depositors, in practice it lacks the required strength because due to the sheer size of deposit holders in India, a series of bank failures in case of wider financial crisis could impose on DICGC a huge liability, which it may not be able to handle. Furthermore, the main purpose of the FSB's proposal for deposit insurance was to help preserve the confidence of the depositors in the market. A low threshold for depositors' protection such as that offered in India does not infuse confidence.

For India, there could be a hybrid approach to ensure a higher threshold for deposit insurance coverage close to that offered by developed economies, while depositors could be offered additional optional coverage managed by a separate agency, for which they would have to pay a premium.

Improving deposit insurance alone will not resolve the problem. Improving the position of uninsured depositors in the hierarchy of claims in insolvency would be a complementary step.

<sup>212</sup>See Iain Withers and William Schomberg, 'HSBC rescues British arm of stricken Silicon Valley Bank' (*Reuters*, 13 March 2023), available at <<https://www.reuters.com/markets/deals/hsbc-says-it-has-acquired-silicon-valley-bank-uk-2023-03-13/>>.

<sup>213</sup>Idem.

<sup>214</sup>See <<https://www.rbi.org.in/commonperson/English/Scripts/FAQs.aspx?Id=272>>.

In such a scenario, the downside is that other creditors (bondholders) including those with preference could be sacrificed or suffer additional losses. The EU's proposal for a single depositors' tier enjoying a preference in the hierarchy of claims moves in this direction but is not a radical improvement as certain EU countries and the US already offer such status to all depositors.

An area where both the literature and regulators agree<sup>215</sup> is that it will improve the situation for depositors is the improved performance of the prudential framework and of bank supervision. In this area, the solution may not necessarily come from adoption of new rules but from improved performance in the implementation of existing ones. In addition, some rule improvement in the area of capital and liquidity ratios<sup>216</sup> to account for the more rapid nature and bigger size of bank runs could be helpful to reassure depositors and impose more bank discipline.

Furthermore, there is need to expand the role of resolution beyond the large banks in the case of bank failures that long been proposed as an important way to improve the effectiveness of the framework and reinforce confidence. The GFC was a large-bank problem, but history of bank failures has shown that crisis can also emerge from medium-sized banks under certain, not necessarily rare, market circumstances. Even after the reforms proposed in the EU so far as a result of the recent turmoil, the majority of bank failures will still be managed through insolvency rather than resolution. However, the benefits of using insolvency on the issue of the use of public funds (insolvency typically leads to liquidation and does not require state aid) are not as substantial as often claimed. In the EU, insolvency is often used by national governments to provide financial support to the failed banks. While it is still advisable to maintain the two separate systems (many bank failures involve small banks posing low risk of contagion and can be quickly liquidated without public fund access), the need for more frequent use of resolution has clearly emerged from the March 2023 bank failures. The principle should be that if the cost for the state will be higher through insolvency, resolution should be used instead as in the latter case, industry resources will be also available, which could reduce state burden.

The expansive use of industry-funded DGSs beyond the reimbursement of insured depositors in resolution in the EU is a positive step as the new use of these funds can help offer access to resolution to small-sized and medium-sized banks currently struggling to meet the 8% liability threshold for inclusion to the scheme. In this area, the EU has corrected a problem already identified by the industry and the literature about the more restrictive rules for access to resolution in the EU, compared to FSB recommendation and the practice of international counterparties, such as in USA. The relevant 'downgrading' of DGS claims in insolvency to equal status as uninsured deposits in the EU is also positive, as it improves the chances the DGS funds will be actually used in resolution. However, the Indian approach is in complete contrast to this.

India's current scheme leaves a large number of depositors uninsured (amount above the insured sum). Smaller deposits may be better protected, but large deposits are at grave risk. If a bank goes into liquidation, DICGC is liable to pay to the liquidator the claim amount of each depositor only up to INR 5 lakhs within 2 months from the date of receipt of a claim list from the liquidator.<sup>217</sup> Even where a bank undergoes reconstruction or amalgamated or is merged with another bank, DICGC pays the bank concerned the difference between the full amount of deposit or the limit of insurance cover in force at the time, whichever is less and the amount received by him under the reconstruction or amalgamation scheme within 2 months from the

<sup>215</sup>For more discussion, see: <<https://www.bis.org/publ/work39.pdf>>.

<sup>216</sup>Idem.

<sup>217</sup>Section 17, DICGC Act 1961, available at <[https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/dicgc\\_act.pdf](https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/dicgc_act.pdf)>.

date of receipt of claim list from the transferee bank or Chief Executive Officer of the insured bank/transferee bank as the case may be.<sup>218</sup>

The March 2023 crisis confirmed that, while bank runs have the same form as before, they now develop at a much higher speed and size facilitated by the expansive role of social media, which allow for the instant dissemination to a global audience of information (or disinformation) about a bank's troubles, facilitating depositors coordination and speeding up the formation of bank run, which is now more sizeable as more depositors than in the past can act fast. These changes significantly reduce the response time available to regulators and banks and require action. A key issue for debate is if action should include steps to increase liquidity buffers by increasing liquidity ratios<sup>219</sup> or if other measures should be adopted aiming at better controlling rather than preventing bank run by providing easier bank access to emergency liquidity support by central banks in case a bank run.

In the former case, the risk of bank run is reduced but not eliminated, while banks could be forced to reduce lending in order to preserve more liquidity, which will have negative impact on the economy.<sup>220</sup> In the latter case, bank runs would not inevitably result in bank failure and transfer to resolution/insolvency, which raises risks to financial stability and market confidence in the financial system, but is also associated with costs. Instead, the bank run could run its course and the bank could potentially survive. However, this option cannot fully prevent bank failure and is not without costs as the central bank will require collateral for the emergency liquidity support, which cannot be unlimited, while a bank suffering from a big bank run especially if the latter is linked to banks' flawed business model is unlikely to survive even under this option. A right balance has to be found, and the March 2023 crisis confirmed that this balance has to be different than the current, which cannot withstand the type of shock that SVB and other mid-sized banks experienced.

Finally, the case of Credit Suisse has provided clear evidence that regardless of how well thought-out and presented a framework for the resolution of banks is, the financial services industry and markets are very complex and evolve at breakneck speed, often resulting in regulators having to act in ways that do not meet market's expectation and in some cases, also in potential defiance of their own-established practices. In the Credit Suisse case, the decision of Swiss authorities to avoid using resolution and to wipe out bondholders before shareholders was not in violation of Swiss law but was contrary to what the market expected as the Swiss authorities seemed to have differentiated themselves from their international counterparts and FSB recommendations. Similarly, the decision of Swiss authorities may have helped to restore market confidence in a period of crisis, but longer term the creation of a super-bank with total assets of USD 5 trillion,<sup>221</sup> far exceeding the gross domestic product (GDP) of Switzerland and with dominant position in the Swiss financial markets does not inspire confidence in regard to the maintenance of a level playing field in those markets or the financial stability longer term.

Swiss authorities are not alone in using solutions to bank failures that appear to deviate from international standards that Switzerland has subscribed to. The unpredictability of financial crises and the fast-changing nature of the financial system will continue to force regulators

<sup>218</sup>See <[https://www.dicgc.org.in/FD\\_A-GuideToDepositInsurance.html#q3](https://www.dicgc.org.in/FD_A-GuideToDepositInsurance.html#q3)>.

<sup>219</sup>See also Andrew Bailey, 'Monetary and financial stability—lessons from recent times' (Speech to the Institute of International Finance, Washington DC, 12 April 2023).

<sup>220</sup>For a discussion, see Restoy (above note 197).

<sup>221</sup>UBS, 'UBS to acquire Credit Suisse' (19 March 2023), available at <<https://www.ubs.com/global/en/media/display-page-ndp/en-20230319-tree.html>>.

to resort to methods that could be deemed controversial. Still, it is important for financial stability the ‘unorthodox’ market interventions to be limited in scope and frequency and be used only as last resort.

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