

# FRDI Bill: In its current form it will throw up challenges for every banking segment

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The Financial Resolution and Deposit Insurance (FRDI) Bill raises some very interesting issues for discussion. Banks are very unique entities. (PTI)

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The Financial Resolution and Deposit Insurance (FRDI) Bill raises some very interesting issues for discussion. Banks are very unique entities. In case of non-bank corporates, the equity-holders own and take the risk of the enterprise while the managers run the show on leverage. i.e., money borrowed from institutions. When the enterprise fails, the owners take the hit to the extent of their equity stake while their private property remains unattached. The problem is now on the lenders which the NPA story is all about while managers continue with their business. This is the classic principal-agent conundrum. Now, in case of banks, the government or shareholders own the company, get managers to run the entity, but

play around with the depositors' money. It is not surprising that today, in the midst of heightened emotions, the complaint is that banks have made a mockery of deposit money, as this is the essential raw material. At present, losses lead to erosion of net worth and the owners—for PSBs, its the government—have to infuse capital.

Losses accumulated due to high NPA provisioning, for example, can wipe out the equity value of the owners. So far, it sounds okay. But the FRDI Bill speaks of the deposit-holders, too, being made a part of the bail-in process; this implies that they will have to also bear with the losses if the issue has to be resolved. This means that if the bank is a PSB, the government can clearly say that it will not infuse funds but simply let deposit-holders take the hit. The equity capital is any way low for banks which run on deposits and, hence, would not matter even if it is eroded. In a way, the loss is being shared with the deposit-holders (who are the equivalent of lenders for non-banks). The deposit-holders are already at the receiving end in the new mantra of banking. First, the return on deposits is very low. Second, it gets taxed unlike equity or some social funding schemes. Third, the insurance given today is only for up to Rs 1 lakh. Fourth, the deposit-holder is hammered for every service that is rendered by the bank. While entry into the branch is penalised, access to ATMs meets the same treatment. NEFT transactions get charged and, hence, almost all services that were free earlier have now been on the price-list. Banks state that if you want service, pay for it or else go elsewhere. Since most banks act as oligopolies, the same cost trickles in unless the account is a privilege account.

The last straw will be when the account-holder is told that any mismanagement in the operation of banks will be a cost imposed on them. Now, the situation reads like this. The government or the shareholders of private banks will reap the dividend when profits increase. They will also appoint their personnel to the management who, in turn, will decide on the remuneration and bonuses. However, when things go wrong, the burden will fall on the deposit-holder. This may be the most extreme situation conceivable, but cannot be ruled out. Even today, the issue of recapitalisation bonds points to this hilarious anomaly. Banks have excess funds which they are not able to deploy because demonetisation brought in a barrage of deposits. As these deposits reside in reverse repos, the banks will be glad to invest the same in these recap bonds issued by the government which in turn will be invested as equity (equity or bonds) in the banks. In the situation outlined earlier, a bank failure could just mean that the deposit is extinguished and the equity remains (as the resolution mechanism dictates). Quite clearly, subjecting deposit-holders

to such risk is not acceptable. In fact, it will be bizarre on the part of the government to do this. Several schemes are being floated for senior citizens who also have locked up savings in bank deposits. The more affluent or market-savvy customers prefer mutual funds and equity, and may be able to get out of this rut. Also, given the resolution committee under the IBC can decide which deposits have to be forfeited, there could once again be discrimination as banks would prefer to protect HNI clients against small deposit-holders, quite like it happens with using bank facilities—the former and corporate clients continue getting free services while the ordinary depositor is charged for everything.

Another aspect to ponder over is if the FRDI Bill were to be implemented in its present form, how would deposit-holders behave. At present, households are agnostic to the name of the bank as it is assumed that money is very safe, even if it is not owned by the government. There is some implicit understanding that money will not be lost and, even when bank failures have occurred in India, these have never meant loss of depositors' money. But, once such a dispensation comes in, there will be a tendency to get all deposits rated as everyone would prefer to go to banks which are doing well and, hence, management quality will matter. This action would mean that as banks start sliding, there will automatically be a tendency for deposits to become mobile and gravitate to the better banks, which will result in further panic with a bank run being the worst-case scenario. This can be very destabilising for the banking system, but cannot be ruled out. [RBI](#), on its part, has to be more on-guard and make sure that banks are always transparent as deposit-holders now would need to know how these banks are performing.

Such a system would also mean that people would progressively start exploring other avenues of savings, which can benefit the mutual funds industry in particular which has tended to deliver marginally better returns (debt schemes) if not higher (equity schemes). Are we prepared for such a scenario where the savings are over-invested in the market-oriented instruments? Also, the government would tend to lose out as the SLR becomes harder to maintain as banks will have to cut down on lending to meet such statutory commitments. Therefore, there will be challenges for every segment of the ecosystem if the Bill is passed in its existing form. There is need to go slow here.