Report of the Working Group on Banking Financial Sector Legislative Reforms Commission

March 1, 2013

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1 Terms of Reference

With a view to outlining and studying comprehensively the banking sector in India, the Financial Sector Legislative Reforms Commission (FSLRC) constituted this Working Group (WG) with the following members:

1. Mrs. K.J. Udeshi (Chairperson)
2. Mr. Y.H. Malegam
3. Mr. Janmejaya Sinha
4. Mr. Aditya Puri
5. Ms. Naina Lal Kidwai
6. Mr. Rajiv Lall
7. Mr. Harsh Vardhan
8. Mr. M.G. Bhide

The Terms of Reference (TOR) of the WG are as follows:

> "The WG on banking will work on all entities which accept deposits for the purpose of lending or investments, money from the public, repayable on demand or otherwise. The TOR of the WG shall be as follows:
>
> 1. To review the legal framework of the financial firms that are engaged in banking, such as commercial banks, Public sector banks (PSBs), co-operative banks, State Bank of India (SBI) and its subsidiaries and regional rural banks in India.
> 2. Unification and harmonisation of the legal and regulatory treatment of these entities.
> 3. To identify legal mechanisms for obtaining equal treatment, regardless of ownership and nationality on questions of competition policy, mergers, take overs, and governance.
> 4. The field of creditors rights and debt recovery should ideally be a feature of company law and debt in general. Yet, finance policy makers have embarked on initiatives such as SARFAESI (2002). What is the appropriate balance that FSLRC should adopt?

5. To review expert committee recommendations, and identify the legal changes which would implement existing recommendations.
6. To review the legal framework through which the regulatory agency would write subordinate legislation on issues of ownership, governance, and compensation of banks.
7. Addressing consumer protection, resolution, systemic risk and prudential regulation in banking."

2 Introduction

The WG reviewed and has built on the recommendations of expert committees (Refer Appendix A) such as the Narasimham Committee Report (1991), Narasimham Committee (1998), Percy Mistry Report (2007) and the Raghuram Rajan Report (2009) in consonance with the broad mandate of the FSLRC. In addition, this WG has also studied the laws on banking in India and the recent regulatory reforms in United Kingdom (UK) and United States of America (USA), among other countries, in the wake of the global financial crisis.

This WG report is divided into the analysis of the following issues while evaluating the banking sector in India in accordance with the TOR:

1. Defining "banking".
2. Level playing field and equal treatment.
3. Consolidation in banking.
4. Ownership, governance and compensation.
5. Holding company structure.
6. Recovery of debts.
7. Securitisation.

3 Summary of recommendations

3.1 Defining "banking"

Recommendation 1: The WG recommends that the definition of banking must be guided by the principle that all deposit taking activities (where the public places deposits with any entity, which are redeemable at par with assured rates of return) must be considered as banking. Consequently entities undertaking such activities must obtain a bank license and /or be subject to the regulatory purview of the banking regulator.

Recommendation 2: On the definition of "banking" the WG recommends that any entity that accepts deposits, has access to clearing and to the Reserve Bank of India (RBI) repo window is a bank. The primary activity of a bank is to accept deposits. Once an entity accepts deposits, it will have access to clearing and discount window of RBI. There may be different categories of banks and the rule of proportionality will be applied in their regulation by the banking regulator.

Recommendation 3: There will be no sub-regulators such as National Bank for Agriculture and Rural Development, National Housing Bank and Small Industries Development Bank in the proposed regulatory architecture. The existing entities may function as financial service providers and will be regulated by the relevant regulator based on their functions.

Recommendation 4: On the issue of co-operatives which collect monies from members/ shareholders, this WG recommends that any co-operative society accepting deposits exceeding a specified value must fall within the regulatory purview of the banking regulator. Co-operative banks are currently regulated under Part V of the BR Act (1949) but many provisions in the BR Act (1949) are not applicable to them. This WG recommends that such exclusions be removed. Co-operative banks must be treated at par with banking companies. This WG also endorses the policy recommendations of the Malegam Report (2011). To deal with the problem of dual control, the Committee recommends the creation of a new organisation structure for Urban Cooperative Banks (UCBs) consisting of a Board of Management (BOM) in addition to the Board of Directors (Board). The Boards would be elected in accordance with the provisions of the respective State Co-operative Societies Acts or the Multi-State Co-operative Act, 2002 and would be regulated and con-

trolled by the Registrar of Co- operative Societies. The Boards would establish a BOM, which shall be entrusted with the responsibility for the control and direction of the affairs of the Bank assisted by a Chief Executive Officer (CEO) who shall have the responsibility for the management of the Bank. RBI would have powers to control and regulate the functioning of the Bank and of its BOM and of the CEO in exactly the same way as it controls and regulates the functioning of the Board and the Chief Executive in the case of a commercial bank.

Recommendation 5: On the issue of companies accepting deposits, the members of the WG deliberated at length. It was pointed out to the WG that the RBI had, in its presentation before the FSLRC submitted that; "Only banks, statutory corporations, companies and co-op societies regulated by the RBI should be allowed to accept deposits from public". While some members were of the opinion that the issue of companies accepting deposits is beyond the purview of this WG, other members expressed the opinion that deposit taking activities should be restricted only to banks. On the question of whether this issue falls within the ambit of this WG, the members deliberated that the RBI Act (1934) already prohibits partnership firms from accepting deposits. Hence some members of the WG recommended extending this prohibition to corporates accepting deposits as well. This requires amending Section 58A of the Companies Act (1956). The proposed Companies Bill of 2011 is a step in this direction. It places restrictions on the acceptance of deposits by companies. It lays down the procedure for acceptance of deposits by members. A limited class of companies including banks and Non-banking financial company (NBFC)s are allowed to accept deposits from public under the proposed bill.

Recommendation 6: On the regulatory framework of NBFC, this WG recommends that deposit taking NBFCs must obtain a license to operate as a bank and will fall within the regulatory purview of the banking regulator. The class of NBFCs that do not accept deposits from public will not be regulated by the banking regulator. Such NBFCs will be regulated by the Unified Financial Authority (UFA).

Recommendation 7: This WG also considered and debated the recommendations of ICB (2011) and on the issue of ring fencing:

1. This WG recognises the significant role played by NBFCs in providing finance. However, with a view to systemic risk oversight, this WG recognises that credit linkages between banking and non-bank finance should be subject to appropriate regulatory oversight

from the viewpoints of both micro-prudential regulation and systemic risk regulation.

2. Once transition to the Financial holding company (FHC) structure, as contained in the recommendation of this WG, is achieved subsidiaries of banks must only do such activities which banks themselves can undertake.

3. There must be ring-fencing of banks vis-a-vis other non-bank entities. Further, banks must not lend to intermediaries which are not regulated by a financial sector regulator. However, the operation of certain financial institutions such as mutual funds might require access to short-term funding. Such short-term funding must be within stringent prudential regulations.

3.2 Level playing field and equal treatment

FSLRC intends to write laws that are ownership neutral. Currently in the banking sector, laws governing banks are not ownership neutral. A commercial bank is governed by BR Act (1949) and nationalised banks are governed by Banking Acquisition (1970), Banking Acquisition (1980) and BR Act (1949) (to a limited extent). Further, the implicit government guarantee that all obligations will be fulfilled by the Government of India (GOI) only applies to PSBs.

Recommendation 8: This WG recommends that laws relating to banking should be ownership neutral and should provide a level playing field for all banks. As a necessary consequence this WG recommends corporatisation of all PSBs.[1]

Recommendation 9: In case of foreign banks having branches in India, this WG recommends that all such foreign banks set up a Wholly owned subsidiary (WOS) in India. Transition issues will need to be addressed by the GOI so that they do not incur taxation from capital gains, or stamp duty, when they convert from branch operations to WOS.

Recommendation 10: On the issue of deposit taking by co-operative societies this WG recommends that there should be some restriction on deposit taking by co-operative societies and that such activity should

[1] In its submission to the FSLRC, the RBI has made a strong case for integrating the various statutes governing different segments of the banking industry and different dimensions of the banking business into a harmonised law to provide clarity and transparency.

fall under the regulatory purview of the relevant legislation. The deliberation was on whether the restriction should be based on number of members or on the value of deposits. While some members expressed the view that restriction should be based on number of members i.e. a co-operative society accepting deposits from more than 50 members should fall within the regulatory ambit of the RBI, the opinion finally weighed in favour of value of deposits. The WG concluded by recommending that any co-operative credit society accepting deposits exceeding a specified value must follow the provisions of the relevant legislation.

3.3 Consolidation in banking

Recommendation 11: The WG recommends that there should be no exemption from the jurisdiction of the Competition Commission of India (CCI) under the Competition Act (2002) for mergers of banks. The WG, however makes a distinction between voluntary and assisted mergers. All voluntary mergers will be subject to the review and approval by the competition regulator. One of the key recommendations of the FSLRC is the establishment of a resolution corporation to ensure prompt and orderly resolution of weak financial institutions. One of the tools of resolution involves sale or merger of weak firm with a healthy acquirer through appropriate mechanisms of due-diligence. To achieve this framework, the WG recommends that all assisted mergers involving sale of a failing bank to a healthy bank will be done under the supervisory review of the resolution corporation.

Recommendation 12: This WG recommends the corporatisation of all PSBs, such as SBI, its subsidiaries, corresponding new banks within the meaning of the Bank Nationalisation Acts and Regional Rural Bankss (RRBs) by converting them into companies under the Companies Act (1956). This would level the playing field and will also rationalise the merger/ amalgamation provisions by bringing them within a single unified framework under the BR Act (1949). In addition, this WG also endorses the policy approach that co-operative banks accepting "public deposits" must obtain a bank license from the regulator.

3.4 Ownership, Governance and Compensation

On the issue of ownership norms for banks, this WG is of the opinion that safety and soundness in banking, as in many other areas in finance, is integrally related to ownership structure, fit and proper requirements, corporate governance and incentive implications of compensation. All these elements have to be seen in a unified way with an eye to curb excessive incentives for risk-taking or unethical behaviour. From this point of view, it is essential that banks have dispersed shareholding.

The specific recommendations of this WG are:

Recommendation 13: Ownership in banks must be dispersed. The WG recommends that the current position of law in this regard be maintained.

Recommendation 14: Bank supervisors must have powers to comprehensively look at human resource policy documents of a bank and recommend changes to the extent such policies impinge upon excessive risk-taking and soundness. The Board and shareholders of banks must have the power to claw back payments made to the top management in line with the global trend of curbing excessive risk taking by the top management.

Recommendation 15: Regulators must look at compensation policy and structure and its impact upon incentives and the ability of the bank to perform adequate risk management. The focus of supervisors should be upon the incentive implications of the compensation structure. There is a case for rules that require compensation to be spread over longer horizon, with provisions for claw back of payments in certain cases. While there is some thinking on framework for compensation in private and foreign banks, the same needs to be extended to PSBs. The legal and regulatory framework for compensation should give the Board and shareholders the ability to push PSBs towards more rational compensation structures, given the deep links between the problems of risk management, operational controls of PSBs, and the flaws of compensation structure.

Recommendation 16: The notion of fit and proper for the boards of banks needs to be reviewed. The WG is in favour of the recommendations made by the Umarji Report (2008) with regard to removing the restriction on directors on Boards of banks also being directors of other enterprises. However, the Managing Director (MD) would not be

allowed to occupy a board position in group companies/entities.

Recommendation 17: Further, this WG recommends that Section 20(1)(b) of the BR Act (1949), which places restrictions on loans and advances by the Board, must be confined to only loans and advances made to private limited companies or to entities where the director has substantial interest. For the purposes of this recommendation, the entities in which the director is deemed to be substantially interested must be in line with standards used for related party transactions under the Companies Act (1956) and accounting standards. This recommendation is broadly in line with the recommendations of CFSA (2009). Referring to the definition of "substantial interest" in Section 5(ne) of the BR Act (1949), CFSA (2009) was of the view that,

> "this quantitative stipulation (Rs. 5 lakhs or 10% of the paid up capital of a company) has proved to be very low because of inflation and also growth in size of banking companies. It is felt that the quantitative ceiling of Rs. 5 lakhs should be removed and an appropriate percent of the paid-up capital be stipulated"

Hence the definition of substantial interest needs to be revised upwards.

Recommendation 18: With respect to PSBs, the Board, must be given greater powers to nominate members of the appointment committee and the compensation committee of the Board.

Recommendation 19: On governance arrangements, the WG recommends that uniform rule of law must be followed by banks irrespective of ownership. This includes:

1. Separating the position of chairman and managing director in case of PSBs as well.
2. Boards of PSBs must play the same role as any other Board, with the same stipulations as any other type of bank.
3. Fully complying with the listing norms (Securities and Exchange Board of India (SEBI) stock exchange rules) in case of listed entities.

3.5 Holding Company Structure

Recommendation 20: This WG recommends that the current mode of operations of banks under Bank subsidiary model (BSM) is inadequate and there should be a shift towards the FHC model as a preferred model for financial sector in India. The FHC model mitigates the risks spilling over to the bank from other entities in the group. In a holding company model the banking entity will be ring fenced

Recommendation 21: Subsidiaries of banks should only do business that could have been done purely within the bank. If insurance cannot be done by a bank, it should not be done by the subsidiary of a bank.

Recommendation 22: Further, capital of banks should not be allowed to take any risks apart from banking risks, and mechanisms must be put in place through which resources from the bank does not flow up into the FHC or to sister subsidiaries in times of crisis, or otherwise. This is consistent with the ring-fencing approach, where micro-prudential regulation and resolution would face clearly defined bank risks, which are engaged in a well defined business of banking (public deposits that are redeemable at par with assured rates of return), with no other complexities of financial structure.

Recommendation 23: To achieve this transition the GOI must provide a one time exemption to capital gains and stamp duty when such conversion happens.

Recommendation 24: With respect to the structure of the holding company, the Percy Mistry Report (2007) states that the holding company must pursue the business strategy of a unified financial conglomerate. In addition this WG endorses the policy recommendations contained in the Percy Mistry Report (2007) which states that the holding company must be required to comply only with the (Companies Act, 1956) with exchange listing requirements, and should be subject only to systemic risk oversight by the appropriate regulator.

3.6 Resolution of weak banks

Recommendation 25: Considering the issues and gaps in the current legal framework and drawing on the recommendations of standard-setting bodies and international best practises, this WG recommends that a sophisticated resolution corporation be set up that will deal with an

array of financial firms including banks and insurance companies. The mandate of this corporation must not just be deposit insurance. It must concern itself with all financial firms which make intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. A key feature of the resolution corporation must be its swift operation. It must also effectively supervise firms and intervene to resolve them when they show signs of financial fragility but are still solvent. The legal framework must be so designed to enable the resolution corporation to choose between many tools through which the interests of consumers are protected, including sales, assisted sales and mergers.

3.7 Microprudential regulation

Consistent with the FSLRC approach, the law on prudential regulation must be written with a non-sectoral perspective. This WG however, deliberated on the broad principles that should govern the prudential regulation of banks.

Recommendation 26: Prudential regulation should be ownership-neutral. The scope of regulation should be agnostic to the ownership structure of the banks.

Recommendation 27: Quantity and quality of capital should be the core part of prudential regulation of banks.

Recommendation 28: Prudential regulation should cover systemic interconnectedness in the context of the holding company model. As outlined above, one of the core mandates of prudential regulation is to limit the negative externalities arising out of the failure of a systemically important firm. The instruments of prudential regulation should be designed to deal with such kinds of firms.

Recommendation 29: In the proposed regulatory architecture the jurisdiction, approval and enforcement process of regulators is important and needs to be clearly defined in the prudential legislation.

3.8 Consumer Protection

While micro-prudential and systemic risk regulations look to ensure continuity and stability in the financial system, there is a need for consumer protection to prevent abuse of consumers and to ensure consumers are able

to optimally fulfil the functions of the financial system. Market failures create possibilities for abuse of consumers that go beyond the concerns related to safety and stability. Financial service providers can make the consumer sign contracts with unfair terms, mislead or deceive the consumers, provide poor quality service, and so on. These can be addressed through regulations. Currently in India there is no separate law protecting consumers of financial services. Under the current law, i.e. the Consumer Protection Act (1986) a consumer may seek redressal before the consumer forum if he has complaints on unfair trade practices or restrictive trade practices or deficiency of service among other things. A general concern with consumer protection law and the current redressal system is that the consumer redressal forum does not have a proper and clear understanding of financial sector and financial services. Specific concerns related specifically to banking are (IBA, 2012):

1. Exclusion of commercial transactions from the current Consumer Protection Act (1986).
2. Exclusion of companies and other artificial legal entities from the definition of "consumer" under Consumer Protection Act (1986).
3. While under the BR Act (1949) rates of interest charged by banks are not subject to scrutiny by courts, increasingly consumer forums scrutinise rates of interest charged by banks.

Recommendation 30: There is a need for a comprehensive law on consumer protection and a redressal forum focussed on financial services, which cuts across different sectors such as banking, insurance and securities market (Customer Service Department, RBI, 2010).

Recommendation 31: In addition specific consumer protection issues also arise in case of electronic/net banking and lending (RBI, 2011a). The rights and liabilities of parties entering into a net banking transaction is not clearly provided under any law and consumers are not protected by law against unauthorised electronic transfers. In addition liability of lenders towards fair disclosure and treating borrowers fairly is not governed by legislation but through guidelines of RBI. These specific issues are required to be addressed in laws to be written by FSLRC (RBI, 2011a).

3.9 Systemic Risk

The global financial crisis highlights that regulators must look not only at safety and soundness of a particular financial entity but must also look at the stability of a financial system as a whole. In this context:

Recommendation 32: The WG recommends the move towards the FHC model as with appropriate accounting and reporting standards, it will help in identification of systemic risk buildup in large financial conglomerates.

With appropriate accounting and reporting standards the move towards the FHC model will help in identification of systemic risk buildup in large financial conglomerates.

Recommendation 33: This WG endorses the recommendations of CFSA (2009) which recognises the need for a regulatory agency which would conduct periodic assessments of macro-economic risks and risk concentrations. This agency must also monitor functioning of large, systemically important, financial conglomerates anticipating potential risks.

Recommendation 34: While research and academic literature in the field of systemic risk is relatively new, based on the existing experience of countries and as endorsed by its inclusion in the Basel III report, the WG recognises the need for countercyclical capital buffer as a policy tool for dealing with systemic risk (BIS, 2010).

3.10 Recovery of Debts

The RDDBFI (1993) is the law setting up specialised debt recovery tribunals, the Debt Recovery Tribunals (DRTs) which aid banks and financial institutions in recovery of debt. This WG debated the particular issues that have emerged that necessitates further reform in this area. In this context the following are the recommendations of this WG:

Recommendation 35: In our view, the threshold limits for application of RDDBFI (1993) must not be stated in the act. The Central Government must have the power to determine the limit through rules. In addition, the capability and efficiency of DRTs must be measured on an ongoing basis and limitations must be addressed efficiently. The threshold limit after which cases may be filed before the DRT may be decreased only if the efficiency and capability permit.

Recommendation 36: This WG endorses the recommendations of Malegam Report (2011) and recommends a separation of the ownership of UCBs. In this way the banking business would be separated from the co-operative society. This would ensure that the regulatory treatment of the banking arm of the co-operative society is at par with banks. With the implementation of this recommendation the banking arm of co-operative banks must also be granted the same privileges available to banks under SARFAESI (2002) and RDDBFI (1993).

Recommendation 37: Section 14 of SARFAESI (2002) is silent on the time period within which petitions are required to be disposed off by the Chief Metropolitan Magistrate or District Magistrates. Since no time lines are prescribed, these petitions take longer than required to be disposed off leading to unnecessary delays. In Bombay High Court (2011) noting the significant delay caused in enforcing security interests under Section 14 SARFAESI (2002) petitions, the Bombay High Court has prescribed a time line of *two months* for all petitions filed under Section 14 of SARFAESI (2002). This WG recommends that the law should prescribe a time period (perhaps 2 months) within which the District Magistrate or the Chief Metropolitan Magistrate, as the case may be, should dispose off Section 14 petitions. Those who fail to meet the time limit should be required to report the number of cases where they took longer than the prescribed time limit.

Recommendation 38: Neither Section 14 of SARFAESI (2002) nor the rules prescribed under SARFAESI (2002), state what documents are required for filing a petition for enforcing a security. This leads to uncertainty in procedure with different courts requiring different documents leading to unnecessary delays. The Debt Laws Amendment Bill (2011), addresses this issue by providing a list of documents to be filed with a Section 14 petition under SARFAESI (2002). In our view, the proposal in the Debt Laws Amendment Bill (2011) would be sufficient for addressing this issue. This WG recommends the same list of documents to be filed with a Section 14 petition.

Recommendation 39: A petition for enforcing security interest under Section 14 SARFAESI (2002) can only be filed with a District Magistrate or a Chief Metropolitan Magistrate. In present day administrative services, the Deputy Commissioner of a particular district also acts as a District Magistrate. A Deputy Commissioner is an administrative officer principally responsible for overseeing revenue collection, such as collection of land revenue and other public dues. A Chief Metropolitan

Magistrate on the other hand, does not exercise executive and judicial function but is the administrative head of metropolitan courts in India. Since both District Magistrates and Chief Metropolitan Magistrates are involved more in administrative functions than actual day to day judicial functions, there is considerable delay in addressing petitions under Section 14 of SARFAESI (2002). The Debt Laws Amendment Bill (2011) addresses this issue by allowing the District Magistrate or the Chief Metropolitan Magistrate to authorise any officer subordinate to him to take actions for enforcing the security interest. On this issue, it is the view of this WG that the proposals in Debt Laws Amendment Bill (2011) is sufficient to address the problem. If the District Magistrate or the Chief Metropolitan Magistrate is allowed to authorise any officer subordinate to him to take actions for enforcing the security interest it would help in reducing delays.

Recommendation 40: In India our laws give preference to crown debt in the form of taxes and statutory dues over the claims of secured creditors during insolvency and bankruptcy proceedings. Though reforms in certain tax laws now provide priority of secured creditors. Tax dues under Customs Act (1962), Central Excise Act (1944), and service tax under Finance Act (1994) are subject to the claims of secured lenders under RDDBFI (1993) and SARFAESI (2002). While these reforms have only partly addressed the issue, the general principle of priority of secured lenders over crown debts and debts under other welfare legislations such as labour laws is not specifically provided for in our laws as highlighted in Committee on ARCs (2011) and IBA (2011). This WG endorses the recommendations of Raghuram Rajan Report (2009) on rationalising insolvency and bankruptcy proceedings:

1. While it is important to protect employee claims such as overdue wages, there must be a limit, say six months, to which such pay is protected. After the expiry of this period employees must also join the ranks of unsecured creditors.
2. The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.
3. Statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.

Recommendation 41: The purpose of setting up DRTs was to ensure

speedy recovery of debts by setting up a special tribunal system which follows a summary procedure as opposed to a detailed procedure followed by the civil courts. DRTs in India are now plagued with the same problems that afflict civil courts: Huge backlog of cases and insufficient infrastructure. An efficient tribunal system has sufficient resources at its disposal and has well trained and competent staff. If the objective and purpose of setting up DRTs are to be given effect to, one cannot ignore the infrastructure issues that afflict the DRTs.

To address the infrastructure issues that afflict DRTs in India, there is a need to rethink and overhaul the legal framework under RDDBFI (1993):

1. **Objective of DRT:** Amend RDDBFI (1993) to clearly state the objective of RDDBFI (1993), as a special tribunal for providing a mechanism for recovery of debt that is fair, just, economical and quick.

2. **Efficiency of DRT:** Suitably amend RDDBFI (1993) to place an obligation on the appropriate entity to ensure efficient and effective functioning of the system.

3. **Training of judicial and recovery officers:** Suitably amend RDDBFI (1993) and SARFAESI (2002) to place a duty on the appropriate entity for training of judicial and recovery officers.

4. **Uniform procedures:** Amend RDDBFI (1993) to reflect the principle that uniform procedures must be followed by all DRTs.

5. **Comprehensive rules on procedures:** Detailed rules of procedure under the CPC (1908) and rules of evidence under the Evidence Act (1872) are not required to be followed. Keeping this in mind, the rules of procedure for DRTs under RDDBFI (1993), namely the DRT Rules (1993), were drafted. The rules of procedure were intended to be light touch by allowing significant liberty to the tribunals to devise their own methods and standards This has led to inconsistent and differing approaches taken by different DRTs. There is a need to set out comprehensive if not detailed, set of rules of procedure applicable to hearings before DRT to increase certainty of procedure and provide guidance to practitioners.

6. **Quantitative measurements of performance:** Amend RDDBFI (1993) and SARFAESI (2002) to ensure reporting requirements by appropriate authorities for preparing annual reports

which detail revenues received through filing fees, resource allocation, steps taken towards efficient functioning of the tribunals, statistical analysis of cases and workload, time taken to dispose cases, and reasons for delay.

7. **Funding and resource allocation:** There is a need to rethink the funding and resource allocation for DRTs in India. Tribunals do not function efficiently if they are not well funded and do not have sufficient resources at their disposal. The recommendations are two fold:

   (a) **Independence:** Currently, resource allocation for DRTs is done through the Ministry of Finance, Government of India (MOF), through the budgetary process. Financial sector regulators in India, such as SEBI and Insurance Regulatory and Development Authority (IRDA), have the ability to charge fees from regulated entities to cover the cost of their functioning. Independence in funding and resource allocation is important for effective functioning as it allows the entity the operational flexibility. The recommendation is therefore to amend RDDBFI (1993) recognising the principle of independent resource allocation.

   (b) **Quantum of fees:** There is merit in empowering the DRTs to determine the filing fees by keeping in mind the overall costs for their effective functioning. The applicants who file petitions before DRTs are financial institutions which can afford to pay for speedy recovery of loans made by them.[2] Currently, only the Central Government has the power to make regulations prescribing the fees. Since the recommendation of this WG is to grant more independence to DRTs for allocating resources, deciding the quantum of fees should be their prerogative and is a necessary outcome of such independence.

8. **Adopting information technology:** Indian courts have been slow in adopting information technology. While there has been some improvements in communication to the public through websites; there is no movement towards integrating the entire court process into an electronic form. Digitisation of court records and

[2] At present, the cost of filing an original application before the DRT is Rs. 12,000 when the amount of debt owed is Rs. 10 lakhs, subject to a maximum cap of Rs. 1.50 lakhs (Debt Recovery Tribunal, 2012).

computerisation of registries would be beneficial in handling the huge backlog of cases. As an example, digitising the registry of the Supreme Court of India has been beneficial in reducing arrears and in facilitating docket management. The Law Commission of India (2009) also recommends a move towards e-filing of documents and video conferencing of proceedings as an effort to save time and costs. For efficient functioning of DRTs, adopting information technology would help in overall reduction of case backlog and would lead to greater efficiency.

3.11 Securitisation

The SARFAESI (2002) works in conjunction with the RDDBFI (1993) and empowers a bank or a financial institution, who is a secured creditor to take possession of a secured asset and sell it to an asset reconstruction company (ARC) without the intervention of a civil court. This WG debated the particular issues which have arisen in the SARFAESI (2002). In this context the following are the recommendations of this WG:

Recommendation 42: Amend Section 5 of SARFAESI (2002) to allow sale of assets from one ARC to another.

Recommendation 43: Amend Section 9 of SARFAESI (2002) to allow the issue of convertible debt by an ARC. The proposals contained in the Debt Laws Amendment Bill (2011) allows converting only a portion of the debt into equity. It does not allow the conversion of all of the debt into equity, and it does not allow issuing convertible debt which may or may not convert into equity.

Recommendation 44: Suitably amend SARFAESI (2002) to allow all secured creditors who are regulated entities under the purview of the Act

Recommendation 45: Amend Section 12 of SARFAESI (2002) to list enumerated powers of RBI along with principles that reflect factors which will inform RBI of the choice of powers to be used.

Recommendation 46: While stamp duty laws are not within the purview of laws to be rationalised either under FSLRC or within the scope of the TOR of this WG, this WG is of the opinion that there must be rationalisation of stamp duty laws in India. A possible solution could be the levy of transaction tax as opposed to stamp duty. The power to levy

transaction tax lies with the Parliament and a transaction tax similar to that of goods and services tax may be introduced by abolishing stamp duty (IBA, 2012).

Recommendation 47: The recommendations in this part are primarily clarifications and standardisation of the process of securitisation, and are not features of the primary law. Reforms in these areas would lead to smoother functioning and greater clarity in the process of securitisation. Some of these also act as a guide to the enumerated powers/principles to be reflected in the powers of the regulator under Section 12 SARFAESI (2002):

1. **Clarity on sale/lease of business:** Although Section 9(b) of SARFAESI (2002) allows securitisation/reconstruction companies to sell or lease a part of the business of the borrower, the exercise of this power is subject to RBI guidelines, which have not been issued by RBI, refer to RBI (2012c). This WG recommends that since the primary legislation allows sale or lease of a business by an ARC, the regulator must not exercise discretion by not issuing guidelines on substantive rights.

2. **Restructuring support finance:** Borrowers' debts turn into non performing assets (NPAs) on account of their inability to finance the debt. The goal of restructuring is to turn around the profitability of such borrowers. Typically, ARCs fund the purchase of the bad assets by issuing securitisation receipts to Qualified Institutional Buyers (QIBs). ARCs are only allowed to deploy funds to restructure the loan account of the borrower. Deploying of funds by the ARC into the defaulting borrower is not permitted (RBI, 2003). Given that ARCs are in a better position to restructure and revive failing companies there may be merit in allowing ARCs to also deploy funds into the borrowing company. On the basis of the proposals contained in the Debt Laws Amendment Bill (2011), which allows partial conversion of loan into equity, deploying funds into the borrower company should be allowed, as this will act as an incentive for the ARC to restructure the company in a holistic manner. This WG is of the opinion that the regulator must prescribe guidelines, subject to prudential regulations, on when ARCs can deploy funds towards restructuring the borrower company along with the process to be followed.

3. **Pledged shares and exemptions from Takeover Code (2011):** When the underlying security, which has been acquired by an

ARC, are shares held in dematerialised form, there are no statutory provisions or regulatory guidelines allowing substitution of the ARC in place of the original lender. This leads to complications and excessive procedural requirements. Further, while banks and financial institutions have been exempted from the Takeover Code (2011) for pledged shares held by them, similar exemptions have not been made applicable to ARCs (Committee on ARCs, 2011). This WG recommends that substitution of ARCs in place of the original lender, and the exemption from the applicability of the Takeover Code (2011) must be allowed. This would however require appropriate amendments to sub-ordinate legislation by SEBI and Ministry of Company Affairs, Government of India (MCA), as applicable.

4. **Modification of charges:** Companies which mortgage their assets are necessarily required to intimate the Registrar of Companies (ROC) to assist in case of insolvency/winding up. However, currently dormant companies (companies who have not complied with filing of annual returns among other things) are not allowed to change or modify their charge registers in light of recent notifications of the MCA.[3] This leads to a situation where if the assets of the dormant company are securitised and transferred to ARCs, the names of ARCs cannot be substituted leading to difficulties in enforcement proceedings/insolvency and winding up cases (Committee on ARCs, 2011). This WG is of the opinion that modification of charges and exemptions in case of ARCs acquiring NPAs of dormant companies must be allowed. This would however require appropriate clarifications by the MCA.

5. **Central Registry:** The Central Government has set up a central electronic registry under SARFAESI (2002) effective from March 31, 2011 to prevent frauds in loan cases involving multiple loans from different banks. The central registry is maintained by Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) under SARFAESI (2002). The registration of charges can be done online and search of the records of the registry can be done by any person online. This WG is of the opinion that the scope of the registry must be expanded to include

[3]The Ministry of Company Affairs through General Circular 33/ 2001 dated June 1, 2011 notified that unless a company files its updated balance sheet and profit and loss account it will not be able to file any event based compliance forms, including for modification of charges.

encumbrance over any property and not just those which are mortgaged to banks or financial institutions. In addition all existing registration systems such as land registry and filings with the registrar of companies, must be integrated with the central registry so that encumbrance on any property (movable or immovable or intangible) is recorded and can be verified by any person dealing with such property.

4 Regulation of banks

4.1 Rationale for regulation

Financial intermediation is a key economic function, which owes its existence to incomplete markets namely high transaction costs and asymmetry of information. Banks as financial intermediaries mobilise resources and channel them efficiently, creating a more complete market. As financial intermediaries, banks undertake certain important functions, such as managing risks, transforming assets, offering access to payment systems, processing information and monitoring borrowers. Banks also have a role to play in transmission of monetary policy as they act as conduits through which changes in short term interest rates are transmitted (Benston and Jr., 1975).

Information asymmetries between the depositor and the bank make it difficult to monitor the latter as many loans advanced by banks are inherently opaque. Unlike a bond issuance, the loan value advanced by a bank is not just dependent on the market information but also on the relationship between the bank and the borrower. This creates opacity in the loan contract (Merton, 1992). Also, market participants like depositors may not be able to monitor optimally because monitoring has strong positive externalities (Stiglitz, 1993). The cost of monitoring is incurred by the one monitoring, while the benefit is accrued by all market participants.

There are significant negative externalities of a bank failure, particularly for depositors. Unregulated private actions may create outcomes where social marginal costs are greater than private marginal costs. The social marginal costs arising on account of a bank failure has widespread effect on the economy as they are conduits for making payments and means of saving. In contrast, private marginal costs are borne by shareholders and employees of the company. These are likely to be of a smaller magnitude than the social costs (Benston and Kaufman, 1996).

So essentially, regulation and supervision of banking influences strategic behaviour of agents in the system and mitigates the effects of market failure. In this context, one may also view financial stability itself as a public good.

In India, banks are regulated through various prudential instruments including the following:

1. Restrictions on entry, branching, network and mergers.
2. Portfolio restrictions.
3. Mandating deposit insurance.
4. Mandating capital adequacy requirements.
5. Ability of banking regulator to perform audits on the bank.
6. Approving the appointment of directors and CEO of banks.
7. Other instruments (such as regulations preventing money laundering).

4.2 Banking in India

Indian banking has had a long and interesting history, witnessing a shift from private ownership to public ownership to an ecosystem where PSBs co-exist with private banks.

In 1948, one year after independence, RBI became our central banking authority. Subsequently, in 1949, we enacted the BR Act (1949), to empower the RBI *"to regulate, control, and inspect the banks in India"*. The BR Act (1949) also stipulates that no new bank or branch of an existing bank can be opened without a license from RBI and no two banks can have common directors. Initially, most banks in India, except the SBI, continued to be privately owned. This changed with the nationalisation of major banks in India in 1969, when the GOI nationalised 14 largest commercial banks. A second round of nationalisation of six more commercial banks followed in 1980, stating the reason that the GOI needed to have more control of credit delivery. After the second round, GOI controlled almost the entire banking industry.

On the issue of nationalisation of private banks, the global financial crisis highlights the measures taken by governments in developed economies, while bailing out private enterprises, to maintain stability of the economy. The developed western economies such as UK and USA which are proponents of private ownership and liberalisation, had to consider a situation where the

government would own banks and other financial institutions. See Box 1 for a brief discussion on how UK and USA avoided public ownership of banks and other financial entities. This is in contrast to the approach we followed in India during the 1970's and 1980's.

Box 1: UK and USA: Public ownership of private institutions?

Following the financial crisis, the British Government acquired majority shareholding in the Royal Bank of Scotland, Northern Rock plc and Lloyds Banking Group. However, the British Government did not enact statutes for such acquisition and instead setup a separate company, UK Financial Services Investments Limited, for such acquisition. All banks in the UK are subject to the same regulatory requirements and regulatory provisions, and no bank is at an advantageous position to other banks (FSA, 2011).

Similarly, in the USA, the bail out of distressed banks did not occur through acquisition of their shares, but by purchase of the illiquid mortgage backed securities which was the root of the crisis thus avoiding public ownership of private enterprises (Bianco, 2011).

Although the UK and the USA were most affected by the global financial crisis, neither of them initiated reforms for nationalising their financial firms as a fall out of the government bail out. These countries have now initiated reforms to reduce probability of firm failure through various measures.

Starting from early 1990s, the banking system in India has undergone gradual reform. The government started with licensing a small number of private banks. The reforms have had multiple direct and indirect effects such as increased efficiency in certain parts of the banking system (Tianshu Zhao and Ferrari, 2009).

The Indian economy has been growing at a fairly rapid pace in recent years. To sustain this level of growth all the engines of the economy will need to respond proportionately. As emphasised earlier, financial sector, particularly the banking sector, has a significant role in catalysing growth of the economy. Ensuring growth is just one of the challenges. There is also an equally pertinent challenge of ensuring that individuals and enterprises get complete access to financial services. Currently a majority of households do not have access to these services. India still has a long way to go before the financial sector, particularly the banking sector, catches up with the needs of our large and growing economy.

5 Defining "banking"

Banking is a form of financial intermediation and to understand the services provided by a bank, it is useful to study a balance sheet of a typical bank. A

simplified view of the balance sheet of a bank shows (Diamond and Dybvig, 1986):

1. **Liability side:** Principal liabilities of a bank are the deposits that the bank has taken. The other main liability is the owners' equity.
2. **Asset side:** Principal assets of a bank are the loans that the bank has made. Another important entry on the asset side is reserves, namely, vault cash, non interest bearing deposits and securities which the bank maintains in its investment portfolio.

The main services of a bank may be described, as:

1. **Asset services:** Which are provided to the borrowers, by evaluating, monitoring and granting loans.
2. **Liability services:** Which are provided to the depositors by holding their deposits, clearing transactions, providing access to payment systems and maintaining an inventory of currency.
3. **Transformational services:** Which requires no explicit services to borrowers or depositors, but involves providing depositors with returns which are different and preferable from what they could have obtained by holding assets directly and trading them in a competitive exchange market. This involves converting illiquid loans into liquid deposits, or more generally, the creation of liquidity, which is an important function of a bank (Diamond and Dybvig, 1986). Liquidity creation is a service which is almost exclusively provided by banks.

By their very nature of business, banks face an asset-liability mismatch. The loans made by banks tend to be for a longer duration than the term of deposits made by depositors with the bank. Due to this mismatch in duration of a loan and that of a deposit, banks may be subject to a bank run where every depositor may withdraw his deposit ultimately leading to a bankruptcy.

Bank regulations aim to prevent costly bank runs while allowing banks to continue to provide various services. Deposit insurance is generally regarded as the most effective measure to prevent bank runs without hindering banks from creating liquidity. Consequently, bank policies are considered in the context of deposit insurance. With this in place, banks no longer bear the downside risk of their positions since the insurer bears that risk. This creates a moral hazard problem, where there are natural incentives for banks to take on too much risk. Bank policies are typically designed to counteract these risks (Diamond and Dybvig, 1983). The recent global financial crisis

is an example of excessive risk taking by banks, where regulation failed to counteract risk taking of banks and protecting depositors. The "ring fenced" model (UK) and the "Volcker Rule" (USA) are regulatory responses to the moral hazard of deposit insurance and excessive risk taking by banks.

To sum up, in economic theory, banking is the business of taking deposits from households, which are redeemable at par, with assured rates of return. They are backed by State run deposit insurance to protect the small depositors.

5.1 Definition under laws in India

The activity of "banking" is defined under Section 5(b) of the BR Act (1949) to mean:

1. *Accepting for the purpose of lending or investment, of deposits of money from the public;*
2. *Which is repayable on demand, or otherwise;*
3. *Such deposit can be withdrawn by cheque, draft, order, or or otherwise.*

The terms "deposit", or "public deposit" used in the definition of the term "banking" are not defined under the BR Act (1949). The definitions to these terms can however be found in the RBI Act (1934) in the context of NBFCs.

"Deposit" under Section 45I(bb) of the RBI Act (1934) is defined as:

> *deposit includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form, but does not include,*
>
> 1. *amounts raised by way of share capital,*
> 2. *amounts contributed as capital by partners of a firm,*
> 3. *amounts received from a scheduled bank or a co-operative, bank or any other banking company as defined in clause (c) of section 5 of the BR Act (1949).*

"Public deposits" is defined under Section 2(xii) in NBFC Directions (1998). The definition of "public deposit" refers to the definition of "deposit" under Section 45I (bb) of the RBI Act (1934), and excludes certain items, such as, any amount received by a company from any other company, amounts

received by way of subscription of shares and debentures pending their allotment.

5.2 Issues

The four main areas of concern when defining banking are:

1. **Definitional issues:** The courts in India have tried to interpret the term "deposit". The term has been interpreted to mean *"Deposit is a sum of money received with the corresponding obligation to repay the same. Thus, repayment of deposit is an integral part of the transaction of a receipt of deposit"*.[4] The definitions of "deposits" and "public deposits" are overly prescriptive, leaning excessively on prescription or prohibition of certain activities. Not being a principles based definition it has led to litigation on whether the RBI had the power to regulate certain activities carried out by institutions who are cheating the public of their monies.

2. **Entities that accept public deposits but are not classified as banks:** Another area of concern is the issue of public deposits camouflaged as member deposits by certain entities, particularly co-operative societies. Currently, collection of deposits from members/shareholders are not treated as accepting public deposits. Deposits are accepted by enrolling members on tap and by collecting nominal amounts from them, exposing such depositors to serious risks. The BR Act (1949) does not apply to such co-operative societies and they are outside the regulatory purview of RBI (Anand Sinha, 2011). Only borrowers of co-operative societies are eligible to be its members and thus contribute to its share capital. The members of the board of these societies are elected by the borrowers, resulting in policies which are not always in the interests of depositors. This necessitates regulatory intervention to remove the propensity of these societies to follow borrower-oriented policies rather than policies that protect the interests of the depositors.

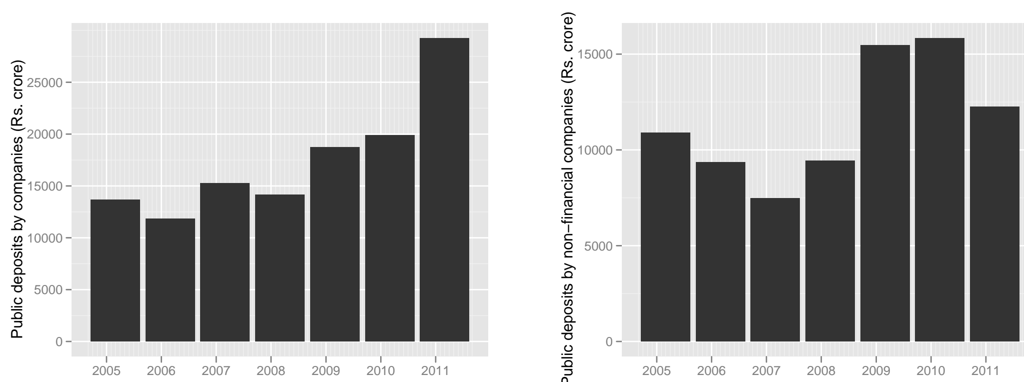
   Similarly, there are companies accepting deposits from the public, thus making their activities similar to those of banks.

   Figure 1 shows that public deposits are a significant source of funding for companies. Section 58A of the Companies Act (1956) deals with invitation, acceptance, renewal and acceptance of deposits. No company

[4]Contention of RBI in, Supreme Court (1992) and cited in Cal HC (1996).

can accept deposits except in the manner and subject to conditions prescribed by the Central Government in consultation with the RBI.[5]

Figure 1 Fixed deposits by all companies and non-financial companies (Rs. crore)



Source: CMIE Prowess database

In addition, there are also deposit taking NBFCs, which accept deposits from the public while at the same time not being classified as banks. The deposit-taking by NBFCs is regulated by the RBI.

Table 1 Public deposits by NBFCs (Rs. crore)

Year	Public deposits by NBFCs	Net Owned Fund
March 2005	20,246	5,510
March 2006	22,842	6,663
March 2007	24,665	8,601
March 2008	24,395	12,261
March 2009	21,548	13,458
March 2010	17,352	16,424
March 2011	11,964	17,975

Source: Report on Trend and Progress of banking in India, RBI, various issues and Karunagaran (2011)

[5]Section 58A of the Companies Act (1956) states:
The Central Government may, in consultation with the RBI, prescribe the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members.

Figure 2 Public deposits by NBFCs (Rs.crore)

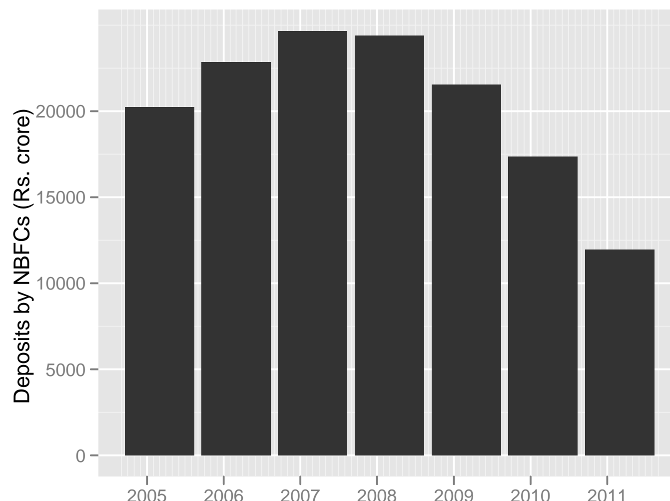


Table 1 and Figure 2 show that the public deposits of NBFCs, after showing a steady increase till 2007, declined sharply by end-March 2011. However, Table 1 also shows that the size of assets have grown steadily, indicating greater demand for the services provided by these companies. As these deposits are not insured by Deposit Insurance and Credit Guarantee Corporation (DICGC), and these entities carry out activities similar to that of banks without being subject to the full purview of banking regulation, it raises concerns about consumer protection and ensuring the stability of the financial system.

In the context of the decline in the size of deposits by NBFCs, Karunagaran (2011) has analysed the sources and application of funds by deposit-taking NBFCs. The analysis reveals that among the sources, there is consistent decline in the share of public deposits. Public deposit as a share of total liabilities has drastically fallen to a low of 3.85%, at the end-March 2011, from a high of 21% at end-March 2001. A major reason for the decline is the stringent regulatory regime towards deposit-taking NBFCs which has resulted in a reduction of the number of NBFCs and the amount of deposits with the them. Consequently, there has been migration of depositors towards the banking system which is better regulated and supervised (Karunagaran, 2011). This implies that the recommendation of this WG is in line with the current regulatory thinking on deposit-taking by NBFCs.

3. **Co-operative banks are not completely under the regulatory**

purview of the RBI: For co-operative banks in India we see dual control. The Registrar of Co-operative Societies or the Central Registrar of Co-operative Societies regulates incorporation/registration and management related activities of co-operative banks. Banking related activities are under the regulatory and supervisory purview of the RBI or National Bank for Agriculture and Rural Development (NABARD). In addition the BR Act (1949) is applicable to co-operative banks only to a limited extent.[6] This has resulted in dual control of such banks by the authorities under the respective cooperative legislations and RBI (CFSA, 2009).

4. **Banks carrying out activities not purely related to banking:** In India the BR Act (1949), does not mandate the separation of retail banking from wholesale/investment banking. However, regulated entities in the financial sector separate these activities and house them in different entities for ease of regulatory oversight, by different regulators. The model currently followed by regulated entities is BSM (RBI Report on FHC, 2011). The recommendations of this WG on the structure is contained in Section 9. However, considering the legislation currently permits such activities to be carried out by banks, there is a need to ensure that the implicit guarantee of the Government to infuse capital to prevent their failure is not extended to these entities/divisions of the bank.

5.3 International experience

5.3.1 Definition of banking

In the USA, the definition of a "bank", and the activity of banking, is primarily linked to the business of receiving deposits which are secured through deposit insurance by the Federal Deposit Insurance Corporation (FDIC).

1. As per Section 3 of the Federal Deposit Insurance Act (1933), the term "bank":

    (a) *means any national bank and State bank, and any Federal branch and insured branch; and*

    (b) *includes any former savings association.*

[6] As an example, the directions of Reserve Bank with respect to fit and proper persons to the directors of banks do not apply to cooperative banks.

2. Further, Section 3 of the Federal Deposit Insurance Act (1933) also defines "State Bank". The term "State bank" means any bank, banking association, trust company, savings bank, industrial bank (or similar depository institution which the Board of Governors finds to be operating substantially in the same manner as an industrial bank), or other banking institution which:

    (a) *is engaged in the business of receiving deposits, other than trust funds; and*

    (b) *is incorporated under the laws of any State or which is operating under the Code of Law for the District of Columbia, including any co-operative bank or other unincorporated bank the deposits of which were insured by the Corporation on the day before the date of the enactment of the FIRREA (1989).*

Since the definition of a bank is primarily focussed on the deposit taking activity, entities accepting deposits as their "business" get covered within the definition of a bank. In addition, entities cannot accept deposits unless they hold deposit insurance through the FDIC. This ensures that unregulated entities do not accept deposits as a business and pose significant risks to the stability of the financial system.

In contrast, in Canada, Section 409 of the Bank Act (1991), defines the business of banking as the following:

1. *Providing any financial service.*
2. *Acting as a financial agent.*
3. *Providing investment counselling services and portfolio management services.*
4. *Issuing payment, credit or charge cards and, in cooperation with others including other financial institutions, operating a payment, credit or charge card plan.*

It can be seen that in Canada the definition of a bank is focussed on the financial intermediation activity, as opposed to the business of accepting deposits as is the case in USA.

5.3.2 Permissible banking activities

The global financial crisis has illustrated that unregulated risk taking by banks could give arise to fiscal burden in the form of bailing them out to protect the utilities provided by them (necessary retail banking services) for which there are no ready alternatives available.

In this regard, the UK constituted the ICB (2011) for creating a more stable and competitive basis for banking in the the long term. ICB (2011) sets the basis for a banking system which is effective and efficient at providing basic banking services by safeguarding retail deposits, operating secure payment systems, efficiently channelling savings to productive investments and managing financial risk.

These objectives are met principally through "ring-fencing", which is achieved by isolating those banking activities where continuous provision of service is vital to the economy and to the customers of banks. This means that certain services of banks which are utilities in the modern economy would be ring-fenced into entities which the exchequer is willing to bail out, whereas other activities of banks which are done for the private gains of banks are placed in entities where the support of the exchequer is not extended. The UK is expected to translate ICB (2011) into legislation on or by 2015 (John Vickers, 2012). For a discussion on the ring fence design in ICB (2011) see Box 2.

As per the ring fence asset split, described in Box 2, approximately two-thirds of activities currently carried out by banks in the UK fall within the prohibited activities and approximately one-sixth falls within permitted and another one- sixth under mandated activities (John Vickers, 2012). An impact assessment conducted by Her Majesty's Treasury (HMT) highlights that the benefits accruing from ring fencing outweighs the costs imposed on banks by requiring them to ring fence (HM Treasury, 2012).

Similarly, in the USA, banking reform agenda has been pursued through the Dodd Frank Act (2010). Section 619 of the Dodd Frank Act (2010), commonly known as the "Volcker Rule", contains prohibitions and restrictions on the ability of a banking and a non bank financial entity, supervised by the Board of Governors of the Federal Reserve System, to engage in proprietary trading and having certain interests in, or relationships with a hedge fund or a private equity fund. An entity that is covered by the Volcker Rule has until July 21, 2014, to fully conform to the requirements of the rule (Federal Reserve, 2012).

Box 2: Ring fence design

In the ring fence design of ICB (2011), activities of banks are classified into three categories:

1. **Mandated**: The following activities are to be carried out *only* by banks which are within the ring fence:
   - Deposits and overdrafts to individuals and small and medium enterprises.
2. **Permitted**: The following activities are permitted (banks have a discretion and they may or may not carry on such activities)to be carried out by banks which are within the ring fence:
   - Deposits and payments for any customer in the European economic activity (EEA);
   - Non financial lending, trade and project finance and advice to customers in the EEA.
3. **Prohibited**: The following activities are prohibited and cannot be carried out by banks within the ring fence:
   - Any non-EEA services.
   - Most trading and underwriting of derivatives and debt. asset-backed or equity securities.
   - Lending to financial companies.

The analysis shows that the current global trend is to move towards curbing excessive risk taking by banks through regulation. This WG debated and considered these international experiences and the recommendations are as listed below.

5.4 Recommendations

Recommendation 1: The WG recommends that the definition of banking must be guided by the principle that all deposit taking activities (where the public places deposits with any entity, which are redeemable at par with assured rates of return) must be considered as banking. Consequently entities undertaking such activities must obtain a bank license and /or be subject to the regulatory purview of the banking regulator.

Recommendation 2: On the definition of "banking" the WG recommends that any entity that accepts deposits, has access to clearing and to the RBI repo window is a bank. The primary activity of a bank is to accept deposits. Once an entity accepts deposits, it will have access to clearing and discount window of RBI. There may be different categories of banks and the rule of proportionality will be applied in their regulation by the banking regulator.

Recommendation 3: There will be no sub-regulators such as National Bank for Agriculture and Rural Development, National Housing Bank and Small Industries Development Bank in the proposed regulatory architecture. The existing entities may function as financial service providers and will be regulated by the relevant regulator based on their functions.

Recommendation 4: On the issue of co-operatives which collect monies from members/ shareholders, this WG recommends that any co-operative society accepting deposits exceeding a specified value must fall within the regulatory purview of the banking regulator. Co-operative banks are currently regulated under Part V of the BR Act (1949) but many provisions in the BR Act (1949) are not applicable to them. This WG recommends that such exclusions be removed. Co-operative banks must be treated at par with banking companies. This WG also endorses the policy recommendations of the Malegam Report (2011). To deal with the problem of dual control, the Committee recommends the creation of a new organisation structure for UCBs consisting of a BOM in addition to the Board. The Boards would be elected in accordance with the provisions of the respective State Co-operative Societies Acts or the Multi-State Co-operative Act, 2002 and would be regulated and controlled by the Registrar of Co- operative Societies. The Boards would establish a BOM, which shall be entrusted with the responsibility for the control and direction of the affairs of the Bank assisted by a CEO who shall have the responsibility for the management of the Bank. RBI would have powers to control and regulate the functioning of the Bank and of its BOM and of the CEO in exactly the same way as it controls and regulates the functioning of the Board and the Chief Executive in the case of a commercial bank.

Recommendation 5: On the issue of companies accepting deposits, the members of the WG deliberated at length. It was pointed out to the WG that the RBI had, in its presentation before the FSLRC submitted that; "Only banks, statutory corporations, companies and co-op societies regulated by the RBI should be allowed to accept deposits from public". While some members were of the opinion that the issue of companies accepting deposits is beyond the purview of this WG, other members expressed the opinion that deposit taking activities should be restricted only to banks. On the question of whether this issue falls within the ambit of this WG, the members deliberated that the RBI Act (1934) already prohibits partnership firms from accepting deposits. Hence some members of the WG recommended extending this prohibi-

tion to corporates accepting deposits as well. This requires amending Section 58A of the Companies Act (1956). The proposed Companies Bill of 2011 is a step in this direction. It places restrictions on the acceptance of deposits by companies. It lays down the procedure for acceptance of deposits by members. A limited class of companies including banks and NBFCs are allowed to accept deposits from public under the provisions of this bill.

Recommendation 6: On the regulatory framework NBFCs this WG recommends that deposit-taking NBFCs must obtain a license to operate as a bank. The class of NBFCs that do not accept deposits from public will not be regulated by the banking regulator. Such NBFCs will be regulated by the UFA.

Recommendation 7: On the issue of ring-fencing this WG made the following recommendations:

1. This WG recognises the significant role played by NBFCs in providing finance. However, with a view to systemic risk oversight, this WG recognises that credit linkages between banking and non-bank finance should be subject to appropriate regulatory oversight from the viewpoints of both micro-prudential regulation and systemic risk regulation.

    - **Implication:** The implementation of this recommendation is in line with the overall regulatory framework currently in place for bank lending to NBFCs (RBI, 2012b). RBI (2012b) imposes prudential ceilings on banks exposure to NBFCs through lending. Restrictions are also in place on investment by banks in securities and investments made by NBFCs. Further, certain activities of NBFCs, such as lending to its subsidiaries and group companies, are not eligible for bank credit. These restrictions need to be fine-tuned to limit the linkages between banks and non-bank finance companies.

2. Subsidiaries of banks should not carry on activities which the parent bank themselves cannot. This recommendation is also intricately linked with the recommendation on the FHC structure contained in Section 9

    - **Implication:** If banks have subsidiaries, such as a securities brokerage house, then such subsidiaries cannot invest in products which the bank itself cannot invest in. This means that risker products which the bank cannot have in its balance

sheet cannot be reflected in the balance sheet of its subsidiary.

3. There must be ring-fencing of banks *vis-a-vis* other non-bank entities. Further, banks must not lend to intermediaries which are not regulated by a financial sector regulator. However, the operation of certain financial institutions such as mutual funds might require access to short-term funding. Such short-term funding must be within stringent prudential regulations.

   - **Implication:** Currently, banks are allowed to lend to entities that are not registered with RBI, such as insurance companies registered under the Insurance Act (1938), nidhi companies notified under Section 620A of the Companies Act (1956), stock broking companies / merchant banking companies registered under Section 12 of the SEBI Act (1992); and housing finance companies regulated by the National Housing Bank (NHB). With the implementation of this recommendation, there would be exposure limits of banks to a particular sector or a particular entity.

6 Level playing field and equal treatment

In an efficient financial system, there is a level playing field in which different institutions compete to provide the same service and no institution dominates others through any privileges it enjoys. This results in a competitive system, where resources are allocated efficiently and society reaps the benefits of maximum utilisation of its productive resources (Raghuram Rajan Report, 2009). Further, once a level playing field is established all institutions providing the same service are treated equally.

In the context of banks in India, there is neither a level playing field nor equal treatment. Functionally, a PSB (such as the SBI) provides the same services as that of a private sector bank (such as HDFC Bank). However, the implicit government guarantee is applicable only to public sector banks. In addition, the law treats the two differently as well. SBI is governed by a special statute, SBI Act (1955) whereas HDFC Bank is governed under the BR Act (1949).

The Banking Acquisition (1970) and Banking Acquisition (1980) are a form of implicit guarantee that all obligations of PSBs will be fulfilled by the

government in the event of a failure (Acharya and Kulkarni, 2012).[7]

There is no such implicit or explicit guarantee in the case of private sector banks. Few empirical studies have examined the issue of guarantees by comparing the performance of public and private sector firms. Acharya and Kulkarni (2012) compares the performance of public and private sector firms before and during the crisis. The authors use a stock market-based measure of systemic risk to determine the systemic risk contributed by each Indian financial firm for the period preceding the global financial crisis (January-December 2007) and compare it to its realised returns during the global financial crisis (January 2008-February 2009). The authors' results demonstrate that public sector firms outperformed private sector firms despite posing greater systemic risk during the period of crisis. The authors find that investors rewarded Indian public sector firms which posed greater systemic risk while they penalised private sector firms which posed similar risks. They attribute this finding to the explicit and implicit government backing of PSBs. The authors find that riskier PSBs, with high ex ante systemic risk and low Tier 1 capital, received greater capital support from the government.

Another instance of unequal treatment is the legal and regulatory framework governing co-operative banks as opposed to the same for banks. Co-operative banks are governed by the provisions of Part V of the BR Act (1949). This part creates a number of exclusions for co-operative banks. For instance, RBI has powers over banking companies and their management under BR Act (1949), but does not have similar powers over co-operative banks under the BR Act (1949). This issue of unequal treatment has also been highlighted by the Committee on Financial Sector Assessment (CFSA). This dual regulation cannot be addressed completely without amending the Constitution of India (1949). However, a partial solution to the problem is to address the issue within the overall limits of the Constitution of India (1949), by separating the boards of the co-operative society and separating the regulation of banking business from the co-operative business (CFSA, 2009). The banking business should be brought fully within the purview of the RBI.

Similarly, an NBFC accepting public deposits, i.e. deposit taking NBFCs, functionally provides the same service as a bank. Yet there is neither a level

[7] For instance, Section 18 of the Banking Acquisition (1970) states

> No provision of law relating to winding up of corporations shall apply to a corresponding new bank and no corresponding new bank shall be placed in liquidation save by order of the Central Government and in such manner as it may direct

playing field nor equal treatment between banks and NBFCs. A deposit taking NBFC is not subject to the same prudential regulations (such as branch licensing) as is applicable to a bank. This gives NBFCs a competitive advantage over traditional banks. Further, NBFCs are companies governed by Companies Act (1956) and commercial private sector banks are governed by the BR Act (1949).

6.1 Multiple laws in India

The presence of multiple legislations governing banks in India can mainly be attributed to historical context. Imperial Bank was acquired after our independence through separate Acts namely, SBI Act (1955) and SBI Subsidiary Act (1959). Nationalisation of banks in 1970s and 1980s happened through separate Acts which dealt with the acquisition. We now have many new private banks which are governed under BR Act (1949), whereas our older banks continue to be governed by special statutes. Another added complication to our framework is the branch model chosen by foreign banks to operate in India. Additionally, we also have NBFCs and co-operative banks as separate categories which are governed under different frameworks. To illustrate, the multiple legislations governing banking in India are:

1. Commercial Banks: BR Act (1949).
2. Nationalised Banks: Banking Acquisition (1970) and Banking Acquisition (1980).
3. State Bank of India and its subsidiaries: SBI Act (1955) and SBI Subsidiary Act (1959).
4. Regional Rural Banks: RRB Act (1976).
5. Co-operative banks and multi state Co-operative banks: Part V of BR Act (1949) and the respective statute of the State on co-operatives.
6. Deposit taking NBFCs: Companies Act (1956).

The mandate of FSLRC is to write ownership neutral laws and the same principle needs to be followed in the banking sector as well. There is a need to rationalise the multiple legislations governing banks. The framework must move away from an entity based regulation to an activity based regulation.

In this regard, Tarapore Committee (2006), in its recommendations on PSB, has recommended the conversion of PSBs into companies under the Companies Act (1956). The rationale for this is to ensure that while the status

of such banks as corporations owned and controlled by the Central Government does not undergo a change, it would allow all banks to be governed by a uniform law, providing greater clarity and transparency.

6.2 Issues

The presence of multiple laws has led to the following issues:

1. Institutions providing functionally equivalent services are not subject to same regulatory, supervisory and tax provisions.

2. There is an uneven playing field due to different legislations and different regulatory treatment of entities providing the same service. As an example, there are different provisions under different laws on voting rights of shareholders. Voting rights of a shareholder in a private bank is capped at 10%, but voting rights of a shareholder of a PSB is restricted to 1%. The CFSA (2009) has also highlighted the concerns with this provision. Even if prospective investors in a bank have holdings of 49% or 74%, their voting rights are restricted to the caps prescribed in law. Although the Banking Laws Amendment (2011) proposes to amend the existing position, it still maintains discrepancy in voting rights. While for commercial banks the restrictions on voting rights are proposed to be removed, for nationalised banks a limit of 10% is proposed. See Box 3 for a discussion on the principal amendments.

   Provisions on restructuring, suspension of business and winding up is also different under different Acts. For instance, RBI has powers to intervene when the managing director of a bank governed under the BR Act (1949) is not a fit and proper person. In case of nationalised banks, RBI does not have such wide powers. On winding up, RBI may apply to the Central Government for imposing a moratorium for banks governed under BR Act (1949). For nationalised banks the power to order a dissolution or a merger/ amalgamation vests solely with the Central Government.

3. Currently, foreign banks operate in India through branches as opposed to being incorporated as subsidiaries. The legal distinction is that branches are not separate legal entities (as they are only agents of the parent), whereas subsidiaries are locally incorporated as a separate legal entity with their own Board (RBI, 2005). This leads to a situation, where foreign branches are treated differently from Indian banks. To illustrate (RBI Branch Authorisation, 2012) further:

Box 3: Banking Laws Amendment Bill

The Bill proposes to make a number of changes on capital expansion, voting rights and supervisory powers of RBI. The Bill also seeks to amend provisions of BR Act (1949) and the Banking Acquisition (1970) and Banking Acquisition (1980). The main proposals include:

(a) Removing the ceiling of Rs. 3,000 crore as the amount of authorised capital nationalised banks must hold. Approval to increase or decrease the authorised capital has to be taken from the Central Government and the RBI.

(b) Allowing nationalised banks to issue additional instruments to raise capital.

(c) Raising the ceiling on voting rights of shareholders of nationalised banks from 1% to 10%.

(d) Removing the existing restrictions on voting rights limited to 10%.[a]

(e) Mandating prior approval of RBI for persons who wish to acquire five percent or more of the share capital of a banking company.

(f) Conferring power on the RBI to call for information and returns from associate enterprises of banks and also inspect them, if required.

(g) Exempting combinations of banking companies from seeking permission from CCI as these are regulated by RBI.

(h) Conferring powers on RBI to supersede the Board of a banking company for not more than 12 months and appoint an administrator for the managing the company during that period.

Source: PRS Legislative Research Bill Summary, The Banking Laws (Amendment) Bill, 2011 (PRS Legislative Research, 2011).

[a]On the recommendations of the Parliamentary Standing Committee on Finance, this proposal stands modified. The cap on voting rights though enhanced, still exists. The voting rights of a single entity in a banking company is capped at 26%.

   (a) Foreign banks are a separate category of applicants as opposed to domestic scheduled commercial banks.

   (b) The liberalised norms to open branches in smaller cities (Tier 2 - Tier 6) applicable to domestic scheduled banks are not applicable to foreign banks (Licensing, 2012).

   (c) A total of 20 branch licenses is given by RBI to all foreign banks put together in any given year (Financial Express, 2006).

4. However there are critical issues with foreign banks operating through the branch route. The regulatory oversight over branches is less stringent than for locally incorporated banks. For instance, provisions of the Companies Act (1956) which contain detailed corporate compliance requirements on matters such as board and management do not apply when entities operate through the branch route as they are not incorporated in India. Further, since capital is fungible the assets of foreign branches in India can be repatriated back to the home country with relative ease which raises concerns of governance and resolution.

6.3 International experience

We examine international experience in the context of the issues highlighted above.

Multiple legislations: In Brazil, the basic legislation governing the banking sector is Law 4595 (1964). As in other developing economies, Brazilian banking sector consists of public as well as private financial institutions. The principal public financial institution in Brazil is the Brazilian Development Bank (BNDES), which also assists in executing federal government investment policies. Other public institutions in Brazil also act as auxiliary bodies assisting in executing federal government investment policies. Under Law 4595 (1964), the National Monetary Council (NMC) is responsible for regulating public financial institutions. Article 24 of Law 4595 (1964) states that non-federal public financial institutions are subject to similar rules as private financial institutions. All public and private financial institutions operating as commercial banks are regulated by the resolutions of NMC. Consequently, there are no separate legislations or norms governing public financial institutions in Brazil and they are treated at par with private financial institutions.

Unequal treatment: The explicit government support given to the BNDES is an example of unequal treatment of banks, primarily based on ownership. In a study conducted it was observed that during crisis, while credit growth of private banks declined considerably, public financial institutions, including BNDES, started increasing their loan volumes massively. Between September 2008 and January 2010, credit from private banks grew by less than 10%, while credit from public banks rose by 50% (Arnold, 2011).

Through explicit government support, BNDES receives considerably cheaper funding than private banks, which allows it to lend at rates that are well below the funding costs of private banks. This creates a non-level playing field since private sector banks are not able to compete in the market for long-term credit(Arnold, 2011).

This is similar to the Indian scenario of PSBs which are perceived to be safer than private sector banks due to the implicit government guarantee.

Co-operatives: The legal and regulatory framework of cooperative banks in Australia is part of a broader category of financial institutions termed as Authorised deposit taking institutions (ADIs). Banks, building societies[8] and credit unions[9] are referred to as ADIs. All ADIs are subject to the same prudential standards but the use of the names 'bank', 'building society' and 'credit union' is subject to corporations meeting certain criteria. In other words, the framework envisages a single regulator for all these entities, as well as similar prudential requirements.

In contrast to the single regulatory framework in Australia for all deposit taking institutions, in the UK, the regulatory framework saw a shift from a differential regime to one where credit unions are treated at par with deposit taking institutions. HMT in 1999 announced that credit unions would fall within the regulatory ambit of Financial Services Authority (FSA) under the FSMA (2000). The new regulatory regime came into effect from July 1, 2002. Key features of the new regime are: (FSA, 2002):

1. Credit Unions must participate in the Financial Services Compensation Scheme by providing its members with deposit protection.

[8]Building societies raise funds primarily by accepting deposits from households, provide loans (mainly mortgage finance for owner-occupied housing) and payment services.

[9]Mutually owned institutions, credit unions provide deposit, personal/housing loan and payment services to members.

2. Credit unions must operate an effective complaints scheme with members having access to the Financial Ombudsman Service.
3. Key personnel running credit unions must meet standards set out in the FSAs rules for approved persons.
4. Credit unions must meet a basic test of solvency and maintain a level of initial capital. Additional capital requirements are applicable to larger credit unions, reflecting their potentially greater impact on consumers should they fail.
5. Credit unions must maintain a minimum liquidity ratio.

To further strengthen the prudential regulatory treatment of credit unions, the FSA released a consultation paper in 2009 setting out proposals for raising the prudential and liquidity requirements for credit unions. The aim of the regulatory initiatives has been to ensure that there is a single point regulation of credit unions on the same principles which are applicable to other regulated entities (Financial Services Authority, 2009).

Foreign banks: In the context of foreign banks, the Australian Prudential Regulation Authority (APRA) allows both branch and wholly subsidiary route to carry on banking business in Australia. There are no restrictions on the number or size of operations of foreign banks in the Australian market. Further, unless otherwise provided, foreign bank owned subsidiaries are subject to the same legislations and prudential requirements as locally owned banks (APRA, 2008).

Foreign banks which operate in USA are given national treatment. The Dodd Frank Act (2010) requires the regulators to apply national treatment policies to Foreign Banking Organisations (FBOs) that do business in the USA through branches, agencies, or subsidiaries. It also mandates the Financial Stability and Oversight Council (FSOC) to give due consideration to the principles of national treatment and equality of competitive opportunity before subjecting a foreign bank holding company or non-bank financial company to prudential requirements.[10]

The UK also places no barriers on the ownership of banks on the basis of nationality. As long as those who seek to control a bank satisfy the "threshold conditions" such as integrity, financial and managerial resources, which is appropriate to run a bank, they may open and operate a bank under the FSMA (2000). Except for the requirement of

[10] *See* Title I Section 121 (d) of Dodd Frank Act (2010)

meeting the threshold conditions there are no barriers to the ownership of banks on the basis of nationality (Huertas, 2008).

6.4 Recommendations

1. **Recommendation 8:** This WG recommends that laws relating to banking should be ownership neutral and should provide a level playing field for all banks. As a necessary consequence this WG recommends corporatisation of all PSBs.[11]

   - **Implication:** All banks (whether private sector, SBI or nationalised banks) must be converted into companies within the meaning of Companies Act (1956) and must be governed by a single unified legislation. Further, as a necessary consequence subordinate regulations made by RBI must also apply equally to all banks, irrespective of whether they are majority controlled by Central Government or by private parties. Further, PSBs will no longer be governed by special statues, and the following special statutes will have to be repealed:

     (a) Banking Acquisition (1970) and Banking Acquisition (1980).

     (b) SBI Act (1955).

     (c) SBI Subsidiary Act (1959).

2. **Recommendation 9:** In the case of foreign banks having branches in India, this WG recommends that all such foreign banks set up a WOS in India. This will require a transition program by GOI to solve the problems of stamp duty and capital gains taxation which would be suffered by foreign bank branches that convert themselves into WOS. The WG recommends this even though it is not within the mandate of writing financial sector laws.

   - **Implication:** Once foreign banks operate through subsidiaries in India, they will be accorded national treatment. This means that the same branch licensing policy applicable to private domestic scheduled commercial banks today will apply to foreign banks as well.

[11]In its submission to the FSLRC, the RBI has made a strong case for integrating the various statutes governing different segments of the banking industry and different dimensions of the banking business into a harmonised law to provide clarity and transparency.

3. **Recommendation 10:** On the issue of deposit taking by co-operative societies this WG recommends that there should be some restriction on deposit taking by co-operative societies and that such activity should fall under the regulatory purview of the relevant legislation. The deliberation was on whether the restriction should be based on number of members or on the value of deposits. While some members expressed the view that restriction should be based on number of members i.e. a co-operative society accepting deposits from more than 50 members should fall within the regulatory ambit of the RBI, the opinion finally weighed in favour of value of deposits. The WG finally concluded by recommending that any co-operative society accepting deposits exceeding a specified value must follow the provisions of the relevant legislation.

7 Consolidation in banking

RBI Consolidation (2008) notes that globally, macro-economic pressures and banking crises have forced banks to consolidate and alter their business strategies. Firm characteristics such as size or organisational structure across segments, or even across lines of business within a segment typically motivates consolidation as a business strategy. The driving force behind consolidation in developed economies was the opportunity to reap benefits of economies of scale and scope. In emerging economies, such as India, consolidation has been driven by the government/regulator in order to restructure the banking systems in the aftermath of crisis. When we view consolidation in India, we need to recognise the need to create a regulatory environment which allows market driven mergers and amalgamations (RBI Consolidation, 2008).

Financial consolidation has implications not only for competition but also for financial stability, monetary policy, efficiency of financial institutions, credit flows and payment and settlement systems (RBI Consolidation, 2008). The optimal size of a bank depends on several factors and differs between countries depending on the level of economic development, the number and diversity of financial institutions/ instruments and the competitive situation in the market (S.P. Talwar, 2001).

In case of Indian banks, their ability to fund large loans hinges on their having a "critical size". Currently, for large infrastructure projects there is a syndication of banks funding the projects due to the critical size problem.

Such a system gives rise to complications such as co-ordination among lenders (CFSA, 2009). It is arguable that consolidation among banks in India might create a bank which has "critical size", but it may also create greater concentration of assets in the economy raising concerns over failure of this large bank (CFSA, 2009).

The banking sector in India is relatively small with a major portion of assets being managed by a few large banks. However, there is a highly fragmented market in India when it comes to medium and smaller size banks, making a case for consolidation. With this in mind, many expert committees, beginning with the Narasimham Committee Report (1991) and Narasimham Committee (1998), and the recent Percy Mistry Report (2007) have recommended consolidation in the banking industry for banks in India to achieve efficiency and economies of scale.

Despite the need for consolidation being recognised very early on, only marginal consolidation has taken place. Since 1991, when the Indian economy was liberalised, there have been only 21 mergers and amalgamations of commercial banks in the Indian banking sector till March 30, 2007 (RBI Consolidation, 2008).

The largest Indian non-financial firms have now outgrown the largest Indian banks. While this WG did not approach the issue of whether consolidation in banking industry is or is not desirable, it debated on the issues which prevent or otherwise hinder the process of consolidation in the banking industry.

7.1 Issues

1. **Supervision:** The Competition Act (2002) provides conditions under Section 5, where combinations are void, such as when the acquirer and the enterprise being acquired have assets of value more than Rs. 1000 crores, or the group to which the enterprise being acquired would jointly have assets of value more than Rs. 4,000 crores. In case of banks, due to their deposit taking nature, these conditions are easily satisfied. Further, since the RBI is the primary regulator of all banks and NBFCs in India, prior approval of RBI is required for merger or amalgamation of entities resulting in banks, (in case of banks governed under the BR Act (1949) and in case of nationalised/ PSBs under the directions of the Central Government consulting with the RBI. Thus the current arrangement is characterised by multiple and often overlapping regulatory framework for combinations of banks.

2. **Different provisions under different Acts:** In India, the law governing banks is different depending on whether the bank is a commercial bank, RRB, SBI, or its subsidiary or a nationalised bank as highlighted above in Section 6.1. Therefore, depending on the bank, the procedure and the provisions relating to mergers or amalgamations would differ. The Leeladhar Commitee (2004), examined the issue of consolidation of banks in India and highlighted the possibilities of mergers in different categories of banks and the statutory requirements of each case:

   (a) A corresponding new bank with another corresponding new bank.

   (b) A corresponding new bank with SBI.

   (c) A corresponding new bank with a subsidiary of SBI.

   (d) SBI or a subsidiary of SBI with a corresponding new bank.

   (e) A banking company with another banking company.

   (f) A banking company with corresponding new bank.

   (g) A corresponding new bank with a banking company.

   (h) A banking company with SBI or a subsidiary of SBI.

   (i) SBI or a subsidiary of SBI with a banking company.

   In light of the above and since different statutes apply depending on the category of the bank, the Leeladhar Commitee (2004) recommended that there should be corporatisation of all banks as a preferable option. This would lead to rationalisation of the process of consolidation as all banks would come under the purview of BR Act (1949).

7.2 International experience

There is a continuing debate on the need for scrutiny of mergers of banks by competition authorities in crisis situations in the financial sector. The recent global financial crisis saw situations such as the Lloyds TSB takeover of HBOS plc, which led to the creation of a banking giant holding close to one-third of savings and mortgage market in the UK (BBC, 2008). The merger was never subjected to competition review and the UK Government decided to proceed with the merger in the interests of financial stability, despite the Office of Fair Trading (OFT) being of the view that this would lead to substantial detriment to competition in certain market segments (Vickers, 2008). Enterprise Act (2002) was amended conferring power upon the

Business and Enterprise Secretary of State to intervene in mergers in order to protect legitimate public interest considerations in certain limited situations. The provision now includes "financial stability" as one of the grounds in which an interference could be made and accordingly approved. Post the global financial crisis, the government in the UK, has shown considerable commitment to ensuring effective competition review with the proposal to create the Financial Conduct Authority (FCA), as well as enabling provisions under the Financial Services Bill, to avoid situations such as the Lloyds TSB takeover of HBOS plc.

The Canadian competition law also contains similar provision which allows its Ministry of Finance to exempt mergers relating to banks, co-operative credit associations, insurance companies, trust and loan companies from the purview of competition authorities if he finds that the merger is in public interest under Section 94 (b) of Canadian Competition Act (1985).

In the USA, although financial institutions are not exempt from anti-trust laws, special provisions apply in case of mergers, where the enforcement responsibility is shared between the Anti-Trust Division and banking regulators. Bank merger laws have competition standards (such as those contained in the Sherman Act (1890) and Clayton Act (1914)) and mergers may be permitted as long as the public interest outweighs the anti-competitive effects. However, bank regulators are required to consult with the Department of Justice and the Attorney General has the powers to seek an injunction against a merger that the bank regulator has approved (OECD, 1998).

The practices followed in the countries discussed above show that consolidation is largely driven by market forces, hence the competition regulator plays a key role.

7.3 Recommendations

1. **Recommendation 11:** The WG recommends that there should be no exemption from the jurisdiction of the CCI under the Competition Act (2002) for mergers of banks. The WG, however makes a distinction between voluntary and assisted mergers. All voluntary mergers will be subject to the review and approval by the competition regulator. One of the key recommendations of the FSLRC is the establishment of a resolution corporation to ensure prompt and orderly resolution of weak financial institutions. An important market oriented tool of resolution involves sale or merger of weak firm with a healthy acquirer

through appropriate mechanisms of due-diligence. In consonance with this framework, the WG recommends that all assisted mergers involving sale of a failing bank to a healthy bank should be done under the supervisory review of the resolution corporation.

- **Implication:** When bank X and bank Y merge creating a resultant bank Z, prior approval of only the competition regulator will be required. The transactions involving merger of a failing bank with a healthy bank would be conducted as pert of the tool-kit of the resolution corporation.

2. **Recommendation 12:** This WG recommends corporatisation of all PSBs, such as SBI, its subsidiaries, corresponding new banks within the meaning of the Bank Nationalisation Acts and RRBs by converting them into companies under the Companies Act (1956). This would level the playing field and will also rationalise the merger/amalgamation provisions by bringing them with a single unified framework under the Competition Act (2002). In addition, this WG also endorses the policy approach that co-operative banks accepting "public deposits" must obtain a bank license from the regulator. Further, mergers and acquisitions of such co-operative banks would also be within the regulatory framework of the CCI in case of voluntary mergers and within the supervisory review of resolution corporation in case of assisted mergers.

   - **Implication:** In a hypothetical scenario of merger of bank X with SBI, a single unified legislative framework will govern the merger. Further, a single unified legislative framework will also govern the merger of a co-operative bank with a scheduled commercial bank or a nationalised bank.

8 Ownership, Governance and Compensation

By the very nature of their business, banks are highly leveraged. They also accept large amounts of uncollateralised public funds as deposits in a fiduciary capacity. The presence of a large and dispersed base of depositors in the stakeholders group sets banks apart from other corporates.

Soundness in banking is intricately linked to the incentives of the top management. There are three parts to this question: The role of high powered incentives, bank promoters who own other businesses, and the problems of corporate governance.

As witnessed in the recent global financial crisis, the risk taking behaviour of banks affects financial and economic fragility. Regulatory agencies are now proposing bank regulations that shape bank risks. In this context, it is important to assess, monitor and regulate the corporate governance mechanisms, such as ownership structure and the incentives of management (Laeven and Levine, 2009). Standard agency theory suggests that ownership structure influences corporate risk taking. An extension of this standard theory when applied to banks suggests that owner controlled banks exhibit higher risk taking behaviour than banks controlled by managers with small shareholding. Laeven and Levine (2009) in an empirical study on risk taking by banks and the correlation of risks taken with ownership structure and national bank regulations, finds that banks with more powerful owners tend to take greater risks. This finding is consistent with the theory that equity holders have stronger incentives to increase risk than non shareholding managers and debt holders. Furthermore, Laeven and Levine (2009) also finds that the impact of bank regulations on bank risk depends critically on the ownership structure of a bank. The effect of the same regulation on the risk taking of a bank can be positive or negative depending on the ownership structure of such bank.

8.1 Legal provisions

Compensation: The RBI has the power, under the BR Act (1949) Act (Section 35B), to regulate compensation of the Board, including the pay and perquisites of the CEO of private sector banks. The regulatory framework differs for public sector banks. The pay scales of employees (including Government Nominee Directors and other whole time and non executive directors) of PSBs are typically fixed by MOF.

Section 19(1) of the Banking Acquisition (1970), speaks of the power of the Board to make regulations, which includes fixing pay scales of employees. The Board of such banking company may make such regulations only with the prior approval of the Central Government and in consultation with RBI. For directors only the Central Government has the power to fix remuneration.

Governance: The BR Act (1949) contains numerous provisions on governance of banks including prescribing qualifications of the Board,[12] restrictions on the chairman of the Board from holding substantial in-

[12] Section 10A of the BR Act (1949).

terest in any other company or firm, or from being engaged in any other business. For PSBs, the Central Government as the largest shareholder is primarily responsible for nominating whole time directors in consultation with the RBI.

Ownership: The BR Act (1949) envisages that ownership of banks must be dispersed, where no one shareholder has voting rights in respect of shares held by him in excess of 10%.[13] For PSBs, the Central Government as the largest shareholder, holds a minimum of 51% and other shareholders are restricted from holding not more than 1% of the total voting rights which is proposed to be increased to 10% under the Banking Laws Amendment (2011).

8.2 International experience and expert committee recommendations

In recent years, post the global financial crisis, it has been argued that the incentive misalignment of bank executives has been one of the main causes for the crisis. In response to this, regulators across the world have initiated reforms mandating that compensation policies at banks be related to long term performance (Ferrarini and Ungureanu, 2011). The Group of Twenty Finance Ministers and Central Bank Governors (G-20) was established post the financial crisis in 2008 by the world leaders to co-ordinate international economic policy. The final declaration of the G-20 contained an action plan with a list of 47 items, 39 of which related to financial regulation, including reform of executive compensation (Veron, 2010). The lead institution responsible for identifying sound policies of compensation is the Financial Stability Board (FSB).

While compensation policies at banks and financial institutions are a prerogative of the Board, the basis of initiating the reforms through regulatory bodies has been to address issues of competitive pressures and the first mover disadvantage (FSB, 2009a). The principles are intended to be applied to significant financial institutions, to reduce excessive risk taking which is linked to the structure of the compensation schemes. They are not intended to prescribe particular designs or levels of individual compensation (FSB, 2009a).

The main principles are (FSB, 2009a):

1. Effective governance of compensation by the Board.

[13] Section 12(2) of the BR Act (1949).

2. Effective alignment of compensation with prudent risk sharing.
3. Effective supervisory oversight and engagement with stakeholders.

The FSB also identified the principal areas where reform is prioritised (FSB, 2009b):

1. **Governance:** Constituting a remuneration committee of the Board to oversee implementation of compensation structures in line with the principles identified by the FSB.
2. **Compensation and capital:** Limiting variable compensation as a percentage of net revenues when it is inconsistent with maintaining a sound capital base.
3. **Pay structure and risk alignment:** Aligning pay structures with the full range of current and potential risks. As an example, a substantial portion of the variable pay structure of senior executives must be in the form of shares or share linked instruments.
4. **Disclosure:** Disclosing to the public the design characteristics of the compensation system of the top management including the criteria for measuring performance and adjusting risks.
5. **Supervisory oversight:** Effectively supervising the implementation of the FSB principles and standards.

Subsequently, in response to the call for comments by FSB, the Basel Committee on Banking Supervision (BCBS), in consultation with the FSB, also published a report in May 2011 on the range of methodologies for risk and performance alignment of remuneration (BIS, 2011). The main objectives of the report are to present some remuneration practices and methodologies that support sound incentives and the challenges or elements influencing the effectiveness of risk alignment that should be considered by banks, when developing their methodologies and by supervisors, when reviewing and assessing practices of banks (BIS, 2011).

Taking into account the stipulations in these documents and the comments received on the draft guidelines, RBI has finalised the compensation guidelines for implementation by private and foreign banks (RBI, 2012a). See Box 4 for a summary of the principal recommendations.

For PSBs, the Raghuram Rajan Report (2009) has recommended a checklist of reforms to reduce the constraints imposed by government ownership, allowing PSBs to hire more talent, make needed investments and react more

Box 4: RBI: Guidelines on Compensation

Compensation Guidelines for Private Sector Banks:

The guidelines of RBI are principally in line with the recommendations of the FSB. The significant factors to consider for aligning compensation of executives at banks are:

1. **Compensation policy:** The Board must prepare a comprehensive compensation policy covering all employees and all major items of remuneration. The policy must also be subject to an annual review.
2. **Board and remuneration committee:** The Board must form a remuneration committee to oversee the framing, review and implementation of the compensation policy. A majority of the members of this committee must be independent non-executive directors who must work in co-ordination with the risk management committee of the Board.
3. **Effective alignment of compensation with prudent risk taking:** The compensation policy formulated must be adjusted for all types of risks and must align the incentives of the top management with long term performance. The guidelines also stipulate that the variable pay must not exceed 70% of the total compensation and there must be clawback provisions for deferred compensation in case of negative contributions of the bank.
4. **Disclosure:** The Board of the bank must disclose compensation structures in its annual report in a prescribed format.

Compensation guidelines for foreign banks: Foreign Banks operating in India are required to submit a declaration to RBI annually, from their head offices, stating that their compensation structure in India, including that of their CEO, is in conformity with the FSB principles and standards. RBI would take this into account while approving the compensation of the CEO.

Regulatory and Supervisory Approval / Oversight: The RBI approval for whole time directors and CEO under the BR Act (1949) must now also take into account FSB principles on compensation policies and practices.

Source: (RBI, 2012a)

dynamically to the rapidly developing environment. These include (Raghuram Rajan Report, 2009):

1. Creating stronger Boards for PSBs: The process of appointing members on the Board of various PSBs must be through an independent selection board of eminently qualified individuals from varied backgrounds. The members of the selection board must retire at staggered intervals so that no future government can easily change its character.

2. Shareholders nominees: Non-government shareholders must be allowed to appoint directors on the Board.

3. Delegation: All decision making must be delegated to the Board of the bank.

8.3 Issues

1. **High powered incentives:** One possibility is to envision banks with professional management teams. The managers would be well paid, but good results for the bank would make a personal difference to the CEO.

   Alternatively, stock options and/or share ownership can make a situation more like a family-promoted bank, where good results for the bank would make a personal difference to the CEO. Such high powered incentives can generate incentives for risk taking, unethical behaviour, political lobbying, corruption, attacks against supervisors and critics. This is a particularly important problem given the governance problems that we face in India.

2. **Bank promoters who own other businesses:** This raises concerns about siphoning money out of the bank into the remainder of the business empire.

3. **Corporate governance:** Professional managers of banks may only look at horizons of 3-5 years; this may give them incentives to take risks which hurt the bank in the long run.

8.4 Recommendations

On the issue of ownership norms for banks, this WG is of the opinion that safety and soundness in banking, as in many other areas in finance, is inte-

grally related to ownership structure, fit and proper requirements, corporate governance and incentive implications of compensation. All these elements have to be seen in a unified way with an eye to curb excessive incentives for risk-taking or unethical behaviour. From this point of view, it is essential that banks have dispersed shareholding.

The specific recommendations of this WG are:

Recommendation 13: Ownership in banks must be dispersed. The WG recommends that the current position of law in this regard be maintained.

Recommendation 14: Bank supervisors must have powers to comprehensively look at human resource policy documents of a bank and recommend changes to the extent such policies impinge upon excessive risk-taking and soundness. The Board and shareholders of banks must have the power to claw back payments made to the top management in line with the global trend of curbing excessive risk taking by the top management.

Recommendation 15: Regulators must look at compensation policy and structure and its impact upon incentives and the ability of the bank to perform adequate risk management. The focus of supervisors should be upon the incentive implications of the compensation structure. There is a case for rules that require compensation to be spread over longer horizon, with provisions for claw back of payments in certain cases. While there is some thinking on framework for compensation in private and foreign banks, the same needs to be extended to PSBs. The legal and regulatory framework for compensation should give the Board and shareholders the ability to push PSBs towards more rational compensation structures, given the deep links between the problems of risk management, operational controls of PSBs, and the flaws of compensation structure.

Recommendation 16: The notion of fit and proper for the boards of banks needs to be reviewed. The WG is in favour of the recommendations made by the Umarji Report (2008) with regard to removing the restriction on directors on Boards of banks also being directors of other enterprises. However, the MD would not be allowed to occupy a board position in group companies/entities.

Recommendation 17: Further, this WG recommends that Section 20(1)(b) of the BR Act (1949), which places restrictions on loans and advances by the Board, must be confined to only loans and advances made to

private limited companies or to entities where the director has substantial interest. For the purposes of this recommendation, the entities in which the director is deemed to be substantially interested must be in line with standards used for related party transactions under the Companies Act (1956) and accounting standards. This recommendation is broadly in line with the recommendations of CFSA (2009). Referring to the definition of "substantial interest" in Section 5(ne) of the BR Act (1949), CFSA (2009) was of the view that,

> "this quantitative stipulation (Rs. 5 lakhs or 10% of the paid up capital of a company) has proved to be very low because of inflation and also growth in size of banking companies. It is felt that the quantitative ceiling of Rs. 5 lakhs should be removed and an appropriate percent of the paid-up capital be stipulated"

Hence the definition of substantial interest needs to be revised upwards.

Recommendation 18: With respect to PSBs, the Board, must be given greater powers to nominate members of the appointment committee and the compensation committee of the Board.

Recommendation 19: On governance arrangements, the WG recommends that uniform rule of law must be followed by banks irrespective of ownership. This includes:

1. Separating the position of chairman and managing director in case of PSBs as well.
2. Boards of PSBs must play the same role as any other Board, with the same stipulations as any other type of bank.
3. Fully complying with the listing norms (SEBI stock exchange rules) in case of listed entities.

9 Holding Company Structure

Global experience shows that deregulation and financial consolidation has led to the development of the FHC allowing commercial banking, insurance, investment banking and other financial activities to be conducted under the same corporate umbrella (Kushmeider, 2005). The FHC model is distinct from the universal banking model, as the FHC holds different entities which

do different commercial activities in the financial sector, whereas in the universal bank model the same entity undertakes different financial activities. The main rationale for separating retail banking from other banking/financial activities stems from:

1. The desire to protect depositors from riskier investment operations.
2. To pre-empt systemic risks from the failure of significant financial institutions.
3. To simplify resolution of these entities.
4. To limit taxpayer exposure in the event of firm failure.

In India, banks have expanded into non-banking activities during the last two decades and have set up subsidiaries in almost all non banking financial areas such as mutual funds, venture capital funds, pension funds, stock broking, insurance and housing finance.

Various committees, such as Raghuram Rajan Report (2009), Percy Mistry Report (2007) and the RBI Report on FHC (2011) have considered the issues that arise due to this diversification of risks and the current BSM. They have recommended a shift towards the FHC model (where the holding company owns many subsidiaries, including a commercial bank which is then just one of the subsidiaries) as a preferred model for financial sector in India as it:

1. Is a good model for capital and risk allocation.
2. Enables better regulatory oversight from a systemic perspective.
3. Enables neater resolution of different entities.
4. Fares better in terms of direct impact of losses of subsidiaries which would be borne by the holding company and not the bank.
5. Provides requisite differentiation in regulatory approach for the holding company *vis-a-vis* the individual entities.

9.1 Legal provisions

The different types of financial activities in which a bank can engage are enumerated in Section 6(1) of the BR Act (1949). Banks can set up subsidiaries for carrying out activities only in one or more of these areas. Under the provisions of Section 19(1) of the BR Act (1949), banks may form subsidiary companies for undertaking types of banking business which they are

otherwise permitted to undertake (under clauses (a) to (o) of sub-section 1 of Section 6 of the BR Act (1949)). As per Section 19(2) of the BR Act (1949), no banking company can hold shares in any company, whether as pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is lower. In furtherance of these restrictions, RBI has also issued detailed guidelines on restrictions in investments in subsidiaries and other companies by banks in December 2011 (RBI, 2011b). Under the guidelines stipulated in RBI (2011b), the investment by a bank in a subsidiary company, financial services company, financial institution, stock and other exchanges should not exceed 10% of the banks paid-up share capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20% of the banks paid-up share capital and reserves.

The objective of these limits is to ensure that banks remain engaged predominantly in banking activities. The undue expansion of banks into other activities could increase risk for banks as they may venture in an area that they do not have much expertise. Failure of the bank in these activities could have a significant impact on the overall position of the bank, ultimately affecting the depositors. Besides, too much expansion in other areas may also distract the bank from its core business i.e. banking, which again will not be in the interest of depositors and the economy.

9.2 Issues

The current legal framework allows banks to follow BSM. This allows banks to undertake all non-bank activities through a subsidiary route i.e. the bank itself floating separate subsidiaries. It is generally believed that such an arrangement unduly concentrates the burden of corporate management of the group and the burden to meet regulatory capital requirement in the bank (RBI Report on FHC, 2011).

From a regulatory viewpoint, one of the key risks posed by BSM is that the parent bank is directly exposed to the functioning of various subsidiaries and any losses incurred by the subsidiaries inevitably impacts the bank balance sheets. Another critical aspect is the risk of transferring an implicit subsidy given to banks such as, deposit insurance and access to the line of credit of the central bank, to non-bank affiliates with consequent moral hazard concerns. These risks can be mitigated to a great extent by the FHC structure.

Global experience shows that a concern with BSM is the difficulty in the resolution of banks. The financial crisis highlighted that some of the large financial conglomerates were structured in a complex way, making it difficult to identify and separate the bad assets for ease of resolution. Setting up clear cut lines of authority and responsibility, along with ring fencing the retail deposit taking function from other investment related activities helps, in ease of resolution. This is possible to achieve under the FHC structure.

In the Indian context, the move towards the FHC structure from the BSM requires considering the following key issues:

1. Ways to mitigate the significant stamp duty expenses incurred for the transfer of assets.

2. Ways to mitigate the significant capital gains tax on account of the transfer/ sale of assets from one entity to another.

3. Taking into account realities of the market while stipulating exposure norms on the bank/ FHC in areas such as housing and securities market.

9.3 International experience

International experience shows that countries are moving towards some form of an arrangement to separate core banking activities from non-banking activities. For a long time, the debate in the USA has primarily focused on whether or not banks should be permitted to engage in non-banking activities. In the aftermath of the banking crisis in the 1930s, the Glass Steagall (1933) ensured a watertight separation between banks and non-bank affiliates for almost six decades. However, Glass Steagall (1933) was repealed and replaced with the Gramm Bliley (1999), which removed most of the legal barriers that separated commercial and investment banking. Therefore, banks became universal banks doing retail as well as securities and insurance underwriting (Wilmart, 2007).

In the wake of the global financial crisis, regulators in USA are moving towards something more similar to the erstwhile Gramm Bliley (1999), in the form of the "Volcker rule", which prohibits proprietary trading by commercial banks. This is also similar to the concept of "ring fencing" as described in ICB (2011), discussed in Section 5.3.2. These regulatory reforms require commercial banks to move away from the universal banking model to a holding company model / ring fenced model.

In Australia, the changes to the financial structures have their origins in the Wallis Inquiry (1997) which recommended that Non-operating holding company (NOHC) structures should be permitted in Australia. The Wallis Inquiry (1997) felt that such a structure would enhance the ability of a holding company to isolate risk within a subsidiary as it would facilitate a legal separation of assets and liabilities of the various entities (RBA, 2007).

9.4 Recommendations

Recommendation 20: This WG recommends that the current mode of operations of banks under BSM is inadequate and there should be a shift towards the FHC model as a preferred model for financial sector in India. The FHC model mitigates the risks spilling over to the bank from other entities in the group. In a holding company model the banking entity will be ring fenced

Recommendation 21: Subsidiaries of banks should only do business that could have been done purely within the bank. If insurance cannot be done by a bank, it should not be done by the subsidiary of a bank.

Recommendation 22: Further, capital of banks should not be allowed to take any risks apart from banking risks, and mechanisms must be put in place through which resources from the bank does not flow up into the FHC or to sister subsidiaries in times of crisis, or otherwise. This is consistent with the ring-fencing approach, where micro-prudential regulation and resolution would face clearly defined bank rinks, which are engaged in a well defined business of banking (public deposits that are redeemable at par with assured rates of return), with no other complexities of financial structure.

Recommendation 23: Transition issues which arise from moving from a predominantly BSM to FHC model are to be addressed. This WG endorses the recommendations of the RBI Report on FHC (2011). Some of the transition issues, which require consideration are (RBI Report on FHC, 2011):

1. Suitable amendments to various taxation provisions such as exemption from the application of capital gains tax.
2. Dividends paid by the FHC must be exempt from dividend distribution tax to the extent that these dividends are used by FHC for investments in other subsidiaries.

3. Identified financial conglomerates having a bank within a group must convert to the FHC model in a time bound manner.

4. In the event conglomerates do not want to convert to FHCs they must confine themselves to only those activities which banks are permitted to undertake.

5. New banks and insurance companies, as and when licensed, would be mandated to operate under the FHC model. For new banks:

   (a) Promoters must be required to float a new holding company, which would initially be 100% owned by the promoters. New banks must be a WOS of this holding company.

   (b) All ownership norms, as prescribed in licensing conditions, will be applicable either at the FHC level or at the bank level.

   (c) In case promoter entity/(ies) already have a non bank financial subsidiary, such subsidiaries must be brought under the holding company in a phased manner.

The transition issues are also analogous to the issues faced by foreign banks which may like to convert their branches into WOS. In the case of foreign banks, this WG, building on the recommendations of RBI (2005), is of the opinion that exemptions from capital gains tax must be provided as a one time exemption for foreign banks to facilitate conversion from the branch model to the WOS model.

Recommendation 24: With respect to the structure of the holding company, the Percy Mistry Report (2007) states that the holding company must pursue the business strategy of a unified financial conglomerate. In addition this WG endorses the policy recommendations contained in the Percy Mistry Report (2007) which states that the holding company must be required to comply only with the (Companies Act, 1956) with exchange listing requirements, and should be subject only to systemic risk oversight by the appropriate regulator.

10 Resolution of weak banks

The global financial crisis has highlighted the importance of a rapid resolution regime where failing firms can be wound down in a prompt manner, removing the unsound or unsafe elements while preserving vital financial ser-

vices for the consumer. In recent times, international standard setting bodies have emphasised the need for national authorities to have effective resolution regimes for all types of financial firms to maintain financial stability, protect the interests of consumers and to ensure prompt pay-outs to depositors (BCBS, 2011a,b).

The Indian framework for resolution is limited to only a sector of financial firms. The mechanisms for such resolution are limited, as are the circumstances in which they come into effect. For banks, the Reserve Bank of India typically uses one of three methods: assist the bank to restructure itself; amalgamate or merge it with another financial firm or close it.

10.1 Legal provisions

The general process to be followed in the case of a failing banking company is provided in the Banking Regulation Act, 1949 (BR Act). The Act allows the High Court to suspend (i.e., order a moratorium upon) the business of a banking company. Such an order may be issued upon the application of a banking company which is temporarily unable to meet its obligations. The application must ordinarily be accompanied by an RBI report indicating that the banking company will be able to pay its debts if the application is granted.

If a banking company is unable to pay its debts, the High Court may order its winding up. RBI may also intervene and apply to the High Court to wind up a banking company in specific circumstances if the banking company:

- fails to comply with minimum paid-up capital and reserves requirements; or
- is no longer entitled to carry on banking business in India (i.e., it loses its license); or
- is prohibited from receiving fresh deposits under BR Act or RBI Act, 1934; or
- fails continuously to comply with any other requirements of BR Act.

Besides these, RBI may also apply for winding up if it believes that:

- a court-sanctioned compromise or arrangement cannot be worked satisfactorily with or without modifications; or

- information furnished to it discloses that the banking company is unable to pay its debts; or
- the continuance of the banking company is prejudicial to the interests of its depositors.

More frequently, a weak bank is resolved by a merger with another bank. This depends on the extent of losses suffered by the failing bank, and the transferee bank's capacity to overcome those losses without any detriment to the interests of its depositors. Two such mergers are possible:

1. Unassisted merger, where a healthy bank volunteers to take over an insolvent bank; and
2. Assisted merger, where an insolvent bank is forcibly merged with another bank (usually a public sector bank).

In the case of assisted mergers, RBI applies to government for a moratorium on a banking company. During the moratorium, RBI may prepare a scheme for reconstructing the banking company, or its merger with any other firm, if it believes that such a move is necessary in public interest; in the interests of depositors; or to secure the proper management of the banking company; or in the interests of the Indian banking system as a whole.

On deposit insurance, DICGC, created and governed under the DICGC Act, 1961, provides customers of all banks with protection of up to a maximum of rupees one lakh held in deposits. Banks are granted insurance cover upon the payment of an insurance premium. This premium is collected half-yearly intervals at a rate decided by RBI (usually a percentage of the assessable deposits of a bank). Flat deposit insurance premiums lead to less risky banks cross-subsidising more risky banks which generates moral hazard.

10.2 Issues

This process has served the Indian banking industry for several years, but legal framework has its limitations. Most importantly, the framework is dispersed across multiple legislations, leading to incongruity and inconsistency.[14] Further, a different legislation may apply depending on the type of financial firm being dealt with. The Banking Regulation Act, 1949, and the Companies Act, 1956, generally deal with banks that have been incorporated as

[14] Subbarao (2011) for instance acknowledges that *"the relevant provisions governing issues such as control of management, acquisition of the financial institution, suspension of business and winding up, are all spread over different laws and regulations"*.

companies. But there are specific legislations which deal with financial firms that have been created by statute. For instance, the State Bank of India Act, 1955 (SBI Act), states:

> No provision of law relating to the winding up of companies shall apply to the State Bank, and the State Bank shall not be placed in liquidation save by order of the central government and in such manner as it may direct.

Additionally, the resolution of cooperative banks pose a concern as they are subject to dual regulation.

Subbarao (2011) has argued that a resolution regime for the financial system needs to address the following issues:

1. Process
   (a) Is the resolution process quick and effective?
   (b) Does the existing legal framework for resolution cover all the different types of financial institutions?
   (c) Does it address all likely eventualities of failure that a firm may face?
   (d) What are the fundamental resolution tools essential for India to deal with failures of all kinds, including large, systemically important institutions?
2. The role of the deposit insurer
   (a) What is the optimal role for a deposit insurer in the resolution regime?
   (b) How are the aspects related to the agency mandate, powers, operational independence and funding considered?
   (c) How can the challenges of cross-subsidisation and moral hazard (as a consequence of fixed deposit insurance premiums) be addressed?
   (d) Should the deposit insurer have access to a special line of credit in the event of an extraordinary situation of financial crisis? If so, what should be the mechanism for such funding?
3. The agency framework within the financial system
   (a) Is the existing agency structure of a regulator and deposit insurer sufficient to address safety issues, or is it time to consider an alter-

native distribution of insolvency responsibilities among the safety net players"?

(b) What are the informational challenges in the existing structure that need to be addressed?

10.3 Recommendations

Recommendation 25: Considering the issues and gaps in the current legal framework and drawing on the recommendations of standard-setting bodies and international best practises, this WG recommends that a sophisticated resolution corporation be set up that will deal with an array of financial firms including banks and insurance companies. The mandate of this corporation must not just be deposit insurance. It must concern itself with all financial firms which make intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. A key feature of the resolution corporation must be its swift operation. It must also effectively supervise firms and intervene to resolve them when they show signs of financial fragility but are still solvent. The legal framework must be so designed to enable the resolution corporation to choose between many tools through which the interests of consumers are protected, including sales, assisted sales and mergers.

11 Micro-prudential regulation of banks

Financial transaction essentially involves a contract between the institution and the consumer. A core element of a financial contract is a *promise*. Promises to make payments in specified times, in specified amounts and in specified circumstances (Wallis Inquiry, 1997). Hypothetically, the exchange of promises is a voluntary transaction that can take place between entities if they have adequate information necessary for making informed judgements about the inherent risks in financial promises. But often, imperfections arise in the system due to information asymmetry. This is especially true for banks where the depositors may not know a bank is failing till it is too late, or the depositors may act on false alarm, and trigger a bank run that may create a crisis for the bank and its depositors. This sets the rationale for micro-prudential regulation of banks. The core objective of micro-prudential regulation is to ensure that certain promises made to consumers are met.

Additionally, the need for prudential regulation also stems from negative externalities arising out of the failures of certain big firms. Certain institutions e.g.large banks hold a position of systemic importance. Their failure would cause adversities not only to their consumers and investors but to the financial system as a whole.

Consistent with the FSLRC approach, the law on prudential regulation would be written with a non-sectoral perspective. This WG however, deliberated on the broad principles that should govern the prudential regulation of banks.

11.1 Recommendations

Recommendation 26: Prudential regulation should be ownership-neutral. The scope of regulation should be agnostic to the ownership structure of the banks.

Recommendation 27: Quantity and quality of capital should be the core part of prudential regulation of banks.

Recommendation 28: Prudential regulation should cover systemic interconnectedness in the context of the holding company model. As outlined above, one of the core mandates of prudential regulation is to limit the negative externalities arising out of the failure of a systemically important firm. The instruments of prudential regulation should be designed to deal with such kinds of firms.

Recommendation 29: In the proposed regulatory architecture the jurisdiction, approval and enforcement process of regulators is important and needs to be clearly defined in the prudential legislation.

12 Consumer Protection

While micro-prudential and systemic risk regulations look to ensure continuity and stability in the financial system, there is a need for consumer protection to prevent abuse of consumers and to ensure consumers are able to optimally fulfil the functions of the financial system. Market failures create possibilities for abuse of consumers that go beyond the concerns related to safety and stability. Financial service providers can make the consumer sign contracts with unfair terms, mislead or deceive the consumers, provide poor quality service, and so on. These can be addressed through regulations.

Currently in India there is no separate law protecting consumers of financial services. Under the current law, i.e. the Consumer Protection Act (1986) a consumer may seek redressal before the consumer forum if he has complaints on unfair trade practices or restrictive trade practices or deficiency of service among other things. A general concern with consumer protection law and the current redressal system is that the consumer redressal forum does not have a proper and clear understanding of financial sector and financial services. Specific concerns related specifically to banking are (IBA, 2012):

1. Exclusion of commercial transactions from the current Consumer Protection Act (1986).
2. Exclusion of companies and other artificial legal entities from the definition of "consumer" under Consumer Protection Act (1986).
3. While under the BR Act (1949) rates of interest charged by banks are not subject to scrutiny by courts, increasingly consumer forums scrutinise rates of interest charged by banks.

12.1 Recommendations

Recommendation 30: There is a need for a comprehensive law on consumer protection and a redressal forum focussed on financial services, which cuts across different sectors such as banking, insurance and securities market (Customer Service Department, RBI, 2010).

Recommendation 31: In addition specific consumer protection issues also arise in case of electronic/net banking and lending (RBI, 2011a). The rights and liabilities of parties entering into a net banking transaction is not clearly provided under any law and consumers are not protected by law against unauthorised electronic transfers. In addition liability of lenders towards fair disclosure and treating borrowers fairly is not governed by legislation but through guidelines of RBI. These specific issues are required to be addressed in laws to be written by FSLRC (RBI, 2011a).

13 Systemic Risk

The global financial crisis highlights that regulators must look not only at safety and soundness of a particular financial entity but must also look at

the stability of a financial system as a whole.

13.1 Recommendations

Recommendation 32: The WG recommends the move towards the FHC model as with appropriate accounting and reporting standards, it will help in identification of systemic risk buildup in large financial conglomerates.

Recommendation 33: There are concerns which arise with insolvency proceedings of entities which are systemically important. In this regard the WG endorses the recommendation of CFSA (2009) to keep resolution of these entities separate from those relating to ordinary companies.

Recommendation 34: This WG endorses the recommendations of CFSA (2009) which recognises the need for a regulatory agency which would conduct periodic assessments of macro-economic risks and risk concentrations. This agency must also monitor functioning of large, systemically important, financial conglomerates anticipating potential risks.

Recommendation 35: While research and academic literature in systemic risk is relatively new, based on the existing experience of the countries and as endorsed by its inclusion in the Basel III report, the WG recognises the need for countercyclical capital buffer as a policy tool for dealing with systemic risk (BIS, 2010).

14 Recovery of debts

The business of lending is a form of financial intermediation. This lending activity is carried out in India by commercial banks, financial institutions and non bank finance companies. These institutions make consumption as well as business loans. When loans are made, they can either be secured or unsecured. Unsecured loans are usually made at higher interest rates, for smaller amounts and where the risk of default is lesser (i.e. to consumers or businesses which have a higher credit rating). However, a major portion of lending to consumers and businesses are in the form of secured loans, where the loans are secured against some collateral.

When borrowers default on loans, the lenders typically re-negotiate the contract. If renegotiation fails, they sell the pledged collateral to recover their money. In addition, if re-negotiations have not yielded performance, the lenders resort to selling the collateral which was pledged. As the process of possessing and selling collateral becomes more difficult, it adds frictions to debt markets that impede the efficiency of the market. Well-functioning debt markets should have efficient debt recovery infrastructure in place, which includes a legal and regulatory framework, a tribunal system for handling disputes efficiently; processing capability at the local levels, and so on. While it is crucial to make the debt recovery process smooth, it is also important to take into account the borrowers' rights and therefore due process should be followed.

Many financial institutions, especially those with limited diversification possibilities on their own balance sheets, transfer their risks and free up their capital by moving some of their portfolio of loans to other institutions or individuals through a process known as *securitisation*. Securitisation is the act of converting a non-traded claim, such as a bank loan, into traded security by issuing claims against it and selling these claims to investors in the form of securities. Essentially, it is a form of financing directly from capital markets where the bank is the originator and repackager of the loan as discussed in Greenbaum and Thakor (2007).

When a borrower defaults in repaying a lender, the lender has the following remedies available:

1. Renegotiate with the borrower so that timely repayments are made.
2. if renegotiation fails enforce the security interest pledged under the loan agreement.
3. In the event the security interest pledged is insufficient to recover the loan amount, resort to litigation in courts.
4. Remove non performing loans from the books of account through securitisation or outright sale of assets (issues in relation to securitisation have been described in Section 15.

Historically, institutional lenders in India could not directly liquidate the collateral of a defaulting borrower without resorting to courts as the process affected property rights. Institutional lenders were therefore first required to institute a suit in a civil court and could only recover their debts by selling the collateral after getting the court's approval. This led to significant delays and led to a crisis situation with the civil courts being clogged with signif-

icant number of debt recovery suits instituted by banks and other financial institutions as highlighted by Visaria (2009).

This issue was first addressed by Narasimham Committee Report (1991), which in its recommendations, emphasised the need to set up a specialised tribunal with powers of adjudication for timely recovery of debts owed to banks and financial institutions. The legal issues in setting up such a specialised tribunal were subsequently examined and RDDBFI (1993) was enacted under which DRTs were set up as a special tribunal. A summary procedure (that is a lean procedure largely based on the principles of natural justice, as opposed to the detailed procedures followed by a civil court) is followed by DRTs under RDDBFI (1993). Once a proceeding is brought by a bank or a financial institutions before the DRT, civil courts no longer have jurisdiction over the particular matter, avoiding a situation where there are multiple suits and proceedings pending before different courts on the same subject matter.[15]

While DRTs have arguably been effective in ensuring a framework that supports speedy recovery of debts, over the years particular issues have emerged that necessitates further reform. In the sub-sections below, these issues have been explored and suggested reforms have been highlighted for consideration.

14.1 Jurisdiction of DRT

Pecuniary jurisdiction clause: Banks and financial institutions can initiate proceedings for recovery of debts before the DRT only when the amount of debt owed exceeds Rs. 10 lakhs. Section 1(4) of RDDBFI (1993) states,

> *"The provisions of this Act shall not apply where the amount of debt due to any bank or financial institution or to a consortium of banks or financial institutions is less than rupees ten lakhs or such other amount, being not less than one lakh rupees, as the Central Government may, by notification, specify"*

[15] The powers of the High Courts are derived under Article 226 of the Constitution of India (1949). The exclusion of civil court jurisdiction under Section 34 of SARFAESI (2002) does not extend to the jurisdiction of High Courts. However, High Courts exercise this jurisdiction only in exceptional cases where there has been arbitrary use of powers by banks.

No notification has been issued by the Central Government extending the jurisdiction of DRTs to situations where the debt owed is less than Rs.10 lakhs.

Better contract enforcement leads to lesser borrower delinquency and credit becoming cheaper, as was witnessed in the years since DRTs came into existence (Visaria, 2009). However, over the years since DRTs became functional the burden on them has also increased. There are now approximately 33 DRTs and 5 Debt Recovery Appellate Tribunals (DRATs) across India and the number of cases pending before DRTs, as of January 31, 2012, is approximately 63,669, an average of 1,930 cases per DRT, indicating significant burden on the existing infrastructure (Ganz and Nair, March 27. 2012).

There is a need to comprehensively overhaul the way DRT functions. The recommendations of this WG on modernising the court infrastructure of DRTs is contained in Section 14.4. Needless to say the DRT are ultimately providing service to their users. As a service provider their performance must be measured against some parameters, which could be for instance, the number of cases filed, the number of cases disposed off and the average time taken for disposing a particular case. The efficiency of the DRTs must be judged on the basis of the performance parameters and steps must be taken to address failings if any. Similarly, if the jurisdiction of the DRTs are to extended to cases which are of small value (less than Rs. lakhs) it must be done if the efficiency parameters of the DRT make a case for such inclusion. The jurisdiction of DRT must not be wantonly decreased to include small value cases if the efficiency of DRT are to be compromised. It is to be noted that however the power to include small value cases by notification as currently contained in the law should be sustained with the following amendments:

1. The amount of Rs. 10 lakhs must be omitted from Section 1(4) of RDDBFI (1993). However, the Central Government must have the power to determine the threshold for cases which may be filed before the DRT.
2. There must be a measure of capability and efficiency of the DRT.
3. The threshold limit after which cases may be filed before the DRT must be capable of being amended by the government through rules only after determination that the DRT is capable of handling increased workload.

Recommendation 36: In our view, the threshold limits for application of RDDBFI (1993) must not be stated in the act. The Central Government must have the power to determine the limit through rules. In addition, the capability and efficiency of DRTs must be measured on an ongoing basis and limitations must be addressed efficiently. The threshold limit after which cases may be filed before the DRT may be decreased only if the efficiency and capability permit.

Co-operative banks: The Supreme Court of India (2007) in its judgement held that a co-operative bank is not a "bank" under RDDBFI (1993), and therefore co-operative banks cannot exercise recovery powers similar to those exercised by banks and financial institutions under RDDBFI (1993). An amendment bill to SARFAESI (2002) and RDDBFI (1993) has recently been introduced in the Lok Sabha in December 2011, namely, Debt Laws Amendment Bill (2011). Debt Laws Amendment Bill (2011) addresses this issue by including multi-state co-operative bank within the definition of "bank" under Section 2 (c) of SARFAESI (2002) and Section 2(d) of RDDBFI (1993). For a detailed discussion on the principal changes introduced by Debt Laws Amendment Bill (2011) see Box 5.

Co-operative banks as a category include not just multi-state co-operative banks but also urban co-operative banks, agricultural credit societies, state co-operative banks and land development banks. It is the view of this WG that the regulatory treatment for co-operative banks should be at par with banking companies. This WG endorses the recommendations of Malegam Report (2011) which offers a solution to the problem of dual control of UCBs. The Malegam Report (2011) recommends that the ownership of a UCB must be segregated into a co-operative society and a bank. The co-operative society would be headed by a Board of Directors whose oversight would be with the Registrar of Co-operative Societies whereas the bank would be headed by a Board of Management whose oversight would be with the RBI. In this way the regulation of co-operatives could be carried out effectively by the RBI and the Registrar of Co-operative Societies. Once the regulatory treatment of the banking arm of co-operative societies and banks is at par with banks the privileges granted to banks under SARFAESI (2002) and the RDDBFI (1993) must also be extended to them.

Recommendation 37: This WG endorses the recommendations of Malegam Report (2011) and recommends a separa-

tion of the ownership of UCBs. In this way the banking business would be separated from the co-operative society. This would ensure that the regulatory treatment of the banking arm of the co-operative society is at par with banks. With the implementation of this recommendation the banking arm of co-operative banks must also be granted the same privileges available to banks under SARFAESI (2002) and RDDBFI (1993).

Box 5: Debt Laws Amendment Bill (2011)

The Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Bill, 2011 Debt Laws Amendment Bill (2011) seeks to introduce changes to (PRS Legislative Research, 2012):

SARFAESI (2002): The principal changes proposed under SARFAESI (2002) are:

1. Allowing conversion of a portion of debt owed by borrower companies into equity shares of the borrower company.
2. Including "multi state co-operative banks" in the definition of banks under Section 2(c).
3. Empowering banks and financial institutions to accept immovable property in full or partial satisfaction of the claim.
4. Allowing banks to file caveat petitions before the grant of any stay of proceedings by DRT.
5. Providing for registration of transactions of securitisation, reconstruction or creating of security interest in the Central Registry.
6. Clarifying the documents to be filed with a petition under Section 14. The documents include:
   (a) An affidavit of the authorised officer of the secured creditor declaring the aggregate amount of financial assistance granted.
   (b) A statement of the total claim of the bank.
   (c) Details of the valid and subsisting security interest of the bank/ financial institution over the properties.
   (d) Statement that the claim is within the limitation period.

RDDBFI (1993): The principal changes proposed under RDDBFI (1993) are:

1. Including "multi state co-operative banks" in the definition of banks under Section 2(d).
2. Permitting multi state co-operative banks to choose whether to initiate recovery proceedings either under the provisions of Multi State Co-operative Societies Act, 2002, or under the provisions of RDDBFI (1993).
3. Enabling banks and financial institutions to enter into any settlement or compromise with the borrower and also to empower DRT to pass an order acknowledging such settlement or compromise.

14.2 Enforcing security interest

RDDBFI (1993) works in conjunction with the provisions of SARFAESI (2002) empowering a bank or any other financial institution, who is a secured creditor to take possession of the secured assets and sell them to an ARC without the intervention of courts. The process by which the enforcement of security interest is contained in Sections 13 and 14 of SARFAESI (2002).

The implementation of Section 14 of SARFAESI (2002) gives rise to the following issues:[16]

No time line prescribed for disposing petitions filed under Section 14 SARFAESI (2002): Section 14 of SARFAESI (2002) is silent on the time period within which petitions are required to be disposed off by the Chief Metropolitan Magistrate or District Magistrates. Since no time lines are prescribed, these petitions take longer than required to be disposed off leading to unnecessary delays. The Bombay High Court (2011) noting the significant delay caused in enforcing security interests under Section 14 SARFAESI (2002) petitions, the Bombay High Court has prescribed a time line of *two months* for all petitions filed under Section 14 of SARFAESI (2002).

Recommendation 38: The law should prescribe a time

[16] Section 14 of SARFAESI (2002) reads,

1. *Where the possession of any secured assets is required to be taken by the secured creditor or if any of the secured asset is required to be sold or transferred by the secured creditor under the provisions of this Act, the secured creditor may, for the purpose if taking possession or control of any such secured asset, request, in writing the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any such secured asset or other documents relating thereto may be situated or found, to take possession thereof, and the Chief Metropolitan Magistrate or, as the case may be, the District Magistrate shall, on request being made to him:*
   (a) *take possession of such assets and documents relating thereto; and*
   (b) *forward such assets and documents to the secured creditor.*
2. *For the purpose of securing compliance with the provisions of subsection (1), the Chief Metropolitan Magistrate or the District Magistrate may take or cause to be taken such steps and use, or cause to be used, such force, as may, in his opinion be necessary.*
3. *No act of the Chief Metropolitan Magistrate or the District Magistrate done in pursuance of this section shall be called in question in any court or before any authority.*

period (perhaps 2 months) within which the District Magistrate or the Chief Metropolitan Magistrate, as the case may be, should dispose off Section 14 petitions. Those who fail to meet the time limit should be required to report the number of cases where they took longer than the prescribed time limit.

Documents required to be submitted with a Section 14 SARFAESI (2002) petition: Neither Section 14 of SARFAESI (2002) nor the rules prescribed under SARFAESI (2002), state what documents are required for filing a petition for enforcing a security. This leads to uncertainty in procedure with different courts requiring different documents leading to unnecessary delays. The Debt Laws Amendment Bill (2011), addresses this issue by providing a list of documents to be filed with a Section 14 petition under SARFAESI (2002). See Box 5 for the clarifications contained under Debt Laws Amendment Bill (2011).

Recommendation 39: In our view, the proposal in the Debt Laws Amendment Bill (2011) would be sufficient for addressing this issue. This WG recommends the same list of documents to be filed with a Section 14 petition.

Delegation by the District Magistrate/Chief Metropolitan Magistrate: A petition for enforcing security interest under Section 14 SARFAESI (2002) can only be filed with a District Magistrate or a Chief Metropolitan Magistrate. In present day administrative services, the Deputy Commissioner of a particular district also acts as a District Magistrate. A Deputy Commissioner is an administrative officer principally responsible for overseeing revenue collection, such as collection of land revenue and other public dues. A Chief Metropolitan Magistrate on the other hand, does not exercise executive and judicial function but is the administrative head of metropolitan courts in India. Since both District Magistrates and Chief Metropolitan Magistrates are involved more in administrative functions than actual day to day judicial functions, there is considerable delay in addressing petitions under Section 14 of SARFAESI (2002). The Debt Laws Amendment Bill (2011) addresses this issue by allowing the District Magistrate or the Chief Metropolitan Magistrate to authorise any officer subordinate to him to take actions for enforcing the security interest.

Recommendation 40: On this issue, the proposal in Debt Laws Amendment Bill (2011) is sufficient to address the problem. If the District Magistrate or the Chief Metropolitan

Magistrate is allowed to authorise any officer subordinate to him to take actions for enforcing the security interest it would help in reducing delays.

14.3 Priority of secured lenders

In India, bankruptcy and insolvency regimes are spread across legislations. For instance, such regimes for companies is under Companies Act (1956). In the case of banks, depending on whether the bank is a commercial bank or a public sector bank, different statutes apply. In the case of individuals and partnership firms it is the Provincial Insolvency Act (1920) and Presidency Insolvency Act (1908), respectively. There is a need to rationalise insolvency regime across laws to bring in a unified insolvency regime as highlighted by the Advisory Group on Bankruptcy Laws (2001).

In the overall framework of FSLRC there will be a resolution process for financial firms. Bankruptcy and insolvency regimes for individuals and non financial firms do not fall within the scope of FSLRC. This WG does however recognise the need to have a harmonised and clear insolvency and bankruptcy framework in case of individuals and non financial firms, especially in the framework for debt recovery and secured lending in line with the recommendations of the CFSA (2009).

In cases of bankruptcy and insolvency of a person, United Nations Commission on International Trade Law (2009) states that the general principles to be followed in a legal framework are:

1. Secured creditors must be given the first preference for pay-out.
2. There must be clear and predictable priority rules.

When these principles are applied in a legal framework, crown debt in the form of statutory dues and taxes raises concerns. Crown debt has historically been given first preference in laws of many countries, even though these dues are unsecured. Priority is given to government tax claims to protect public revenue. Although there is now a clear trend globally to reduce tax priorities. Countries such as Australia, UK, Germany have eliminated all tax priorities, whereas in Canada they have eliminated all but withholding taxes. This trend is based on the view that the government does not need revenue at the expense of other creditors and can make up for its position as an involuntary creditor by using special collection tools at its disposal (International Insolvency Institute, 2005).

Recommendation 41: In India our laws give preference to crown debt in the form of taxes and statutory dues over the claims of secured creditors during insolvency and bankruptcy proceedings. Though reforms in certain tax laws now provide priority of secured creditors. Tax dues under Customs Act (1962), Central Excise Act (1944), and service tax under Finance Act (1994) are subject to the claims of secured lenders under RDDBFI (1993) and SARFAESI (2002). While these reforms have only partly addressed the issue, the general principle of priority of secured lenders over crown debts and debts under other welfare legislations such as labour laws is not specifically provided for in our laws as highlighted in Committee on ARCs (2011) and IBA (2011). The recommendations of Raghuram Rajan Report (2009) on rationalising insolvency and bankruptcy proceedings are:

1. While it is important to protect employee claims such as overdue wages, there must be a limit, say six months, to which such pay is protected. After the expiry of this period employees must also join the ranks of unsecured creditors.

2. The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.

3. Statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.

14.4 Infrastructure issues

The purpose of setting up DRTs was to ensure speedy recovery of debts by setting up a special tribunal system which follows a summary procedure as opposed to a detailed procedure followed by the civil courts. DRTs in India are now plagued with the same problems that afflict civil courts: Huge backlog of cases and insufficient infrastructure. To illustrate, as of January 31, 2012, there were approximately 63,699 cases pending before the DRTs, signifying that on an average there are 1, 930 cases per DRT. Currently, there are 33 DRTs and 5 DRATs throughout India (Ganz and Nair, March 27. 2012).

Financial institutions resort to recover their money by filing suits and applications only as a last resort. The longer the time taken to resolve any case

the higher the costs, both to the financial institution as well as to the borrower. Protracted litigation also gives unscrupulous borrowers time to sell or dispose off the secured assets and causes banks and financial institutions to incur huge opportunity costs (Law Commission of India, 2002).

The Raghuram Rajan Report (2009) highlights some of problems that afflict DRTs:

1. Insufficient number of DRTs and presiding officers.
2. Lack of judicial training for recovery officers (they are officers appointed by the GOI for assisting the presiding officers).
3. Inconsistent procedures followed by different DRTs.
4. Significant delay in proceedings (the recommended time is six months, whereas proceedings actually last for two years or more).

While laws in India are made with noble purposes, the fact that our laws do not provide for creating efficient tribunals and courts, in most cases, defeats the purpose of the law. In the absence of an efficient judicial process, the law loses some of its value as a measure to improve economic certainty and efficiency. In contrast to India, this principle is recognised in laws governing tribunals and courts in developed economies such as UK and Australia. Further, the laws of these countries also have provisions on budgeting, preparing annual reports and analysing statistics relating to workload and pending cases. The courts and tribunals also have a duty to ensure efficient services are provided to the users. See Box6 for a discussion of laws in UK and Australia relating to tribunals.

Box 6: Efficient functioning of courts and tribunals

UK: Tribunals Act (2007) is the principal law governing tribunals in UK. It brings all tribunals under a unified system (the Administrative Justice and Tribunals Council oversees tribunals) and creates an organisational structure among tribunals while also providing for review of decisions of tribunals. Under Section 39 of Tribunals Act (2007):

1. The Lord Chancellor is under a *duty* to ensure that there is an *efficient and effective system* to support the business of:
   (a) the First- tier Tribunal,
   (b) the Upper Tribunal,
   (c) Employment tribunals,
   (d) the Employment Appeal Tribunal, and
   (e) the Asylum and Immigration Tribunal,

Australia: In 1975 the Australian Government established the Administrative Appeals Tribunal as a general administrative tribunal to review a broad range of government decisions such as taxation, insurance and social security. This Tribunal was set up through the enactment of the AAT Act (1975). Under Section 2A of the AAT Act (1975), *"Tribunal's objective: In carrying out its functions, the Tribunal must pursue the objective of providing a mechanism of review that is fair, just, economical, informal and quick."*

In India, under laws governing establishment of tribunals, no entity has a duty for efficient functioning of tribunals and neither do tribunals have such a clear objective.

Currently no court or tribunal system in India prepares any form of an annual report.

There is merit for this WG to consider the infrastructure issues faced by DRTs. An efficient tribunal system has sufficient resources at its disposal and has well trained and competent staff. If the objective and purpose of setting up DRTs are to be given effect to, one cannot ignore the infrastructure issues that afflict the DRTs.

Recommendation 42: To address the infrastructure issues that afflict DRTs in India, there is a need to rethink and overhaul the legal framework under RDDBFI (1993):

1. **Objective of DRT:** Amend RDDBFI (1993) to clearly state the objective of RDDBFI (1993), as a special tribunal for providing a mechanism for recovery of debt that is fair, just, economical and quick.

2. **Efficiency of DRT:** Suitably amend RDDBFI (1993) to place an obligation on the appropriate entity to ensure efficient and effective functioning of the system.

3. **Training of judicial and recovery officers:** Suitably amend RDDBFI (1993) and SARFAESI (2002) to place a

duty on the appropriate entity for training of judicial and recovery officers.

4. **Uniform procedures:** Amend RDDBFI (1993) to reflect the principle that uniform procedures must be followed by all DRTs.

5. **Comprehensive rules on procedures:** Detailed rules of procedure under the CPC (1908) and rules of evidence under the Evidence Act (1872) are not required to be followed. Keeping this in mind, the rules of procedure for DRTs under RDDBFI (1993), namely the DRT Rules (1993), were drafted. The rules of procedure were intended to be light touch by allowing significant liberty to the tribunals to devise their own methods and standards This has led to inconsistent and differing approaches taken by different DRTs. There is a need to set out comprehensive if not detailed, set of rules of procedure applicable to hearings before DRT to increase certainty of procedure and provide guidance to practitioners.

6. **Quantitative measurements of performance:** Amend RDDBFI (1993) and SARFAESI (2002) to ensure reporting requirements by appropriate authorities for preparing annual reports which detail revenues received through filing fees, resource allocation, steps taken towards efficient functioning of the tribunals, statistical analysis of cases and workload, time taken to dispose cases, and reasons for delay.

7. **Funding and resource allocation:** There is a need to rethink the funding and resource allocation for DRTs in India. Tribunals do not function efficiently if they are not well funded and do not have sufficient resources at their disposal. The recommendations are two fold:

   (a) **Independence:** Currently, resource allocation for DRTs is done through the MOF, through the budgetary process. Financial sector regulators in India, such as SEBI and IRDA, have the ability to charge fees from regulated entities to cover the cost of their functioning. Independence in funding and resource allocation is important for effective functioning as it allows the entity the operational flexibility. The recommendation is therefore

to amend RDDBFI (1993) recognising the principle of independent resource allocation.

(b) **Quantum of fees:** There is merit in empowering the DRTs to determine the filing fees by keeping in mind the overall costs for their effective functioning. The applicants who file petitions before DRTs are financial institutions which can afford to pay for speedy recovery of loans made by them.[17] Currently, only the Central Government has the power to make regulations prescribing the fees. Since the recommendation of this WG is to grant more independence to DRTs for allocating resources, deciding the quantum of fees should be their prerogative and is a necessary outcome of such independence.

8. **Adopting information technology:** Indian courts have been slow in adopting information technology. While there has been some improvements in communication to the public through websites; there is no movement towards integrating the entire court process into an electronic form. Digitisation of court records and computerisation of registries would be beneficial in handling the huge backlog of cases. As an example, digitising the registry of the Supreme Court of India has been beneficial in reducing arrears and in facilitating docket management. The Law Commission of India (2009) also recommends a move towards e-filing of documents and video conferencing of proceedings as an effort to save time and costs. For efficient functioning of DRTs, adopting information technology would help in overall reduction of case backlog and would lead to greater efficiency.

15 Securitisation

As described above securitisation is the process of pooling and repackaging homogeneous illiquid assets into marketable securities that can be sold to investors. These marketable securities represent ownership in, or are secured

[17] At present, the cost of filing an original application before the DRT is Rs. 12,000 when the amount of debt owed is Rs. 10 lakhs, subject to a maximum cap of Rs. 1.50 lakhs (Debt Recovery Tribunal, 2012).

by a segregated income producing asset or a pool of assets. This pool of assets (such as immovable or movable property) act as the collateral for the securities (Kashyap and Kashyap, 2010).

ARCs are the investors who purchase loans from banks and financial institutions and convert them into securitisation receipts which they sell to sophisticated investors such as QIBs. The process of securitisation is governed under SARFAESI (2002) in India. The objective of SARFAESI (2002) is:

> *"to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto."*

SARFAESI (2002) helps secured creditors by providing legal recognition to the process of securitisation and allowing the sale of securitisation receipts by an ARC. It also provides special powers to lenders and ARCs by enabling them to take over the assets of the borrowers without resorting to courts (Raghuram Rajan Report, 2009).

15.1 Recommendations in primary legislation

SARFAESI (2002) represents a positive reform in the contract enforcement regime and creditor rights outside bankruptcy. However, there is still scope for further reform. In the years since SARFAESI (2002) was enacted, the following issues have emerged:

Sale of assets by one ARC to another: Section 5 of SARFAESI (2002) sets out the procedure on how a securitisation company or a reconstruction company may acquire financial assets of any bank or a financial institution. The interpretation is that since only banks and financial institutions can acquire financial assets under Section 5 SARFAESI (2002), sale of assets from one ARC to another is not possible (RBI, 2012c). Due to this limitation the following issues arise:

1. If an ARC successfully bids for a bundle of debts, some of which are outside its geographical area of operation, it can do nothing about it.
2. An ARC cannot form a consortium to jointly bid for the assets.

While this may be useful in preventing cartels amongst the ARCs, it also prohibits ARCs from co-operating with each other and offering a competitive price in an auction. There is merit in allowing ARCs to sell assets amongst themselves.

> **Recommendation 43:** Amend Section 5 of SARFAESI (2002) to allow sale of assets from one ARC to another.

Issuing convertible debt: An ARC cannot currently under the provisions of SARFAESI (2002) issue convertible instruments (such as convertible debentures) as a part of the reconstruction strategy for a company (Committee on ARCs, 2011). Although an ARC may take over the management of the business of the borrower company, they cannot raise equity capital in the ailing company by converting the debt, owed by the borrower company, into equity of the borrower company. During reconstruction of a company, this conversion of debt into equity gives the ARC the necessary incentive to turn around the company. This also gives the borrowers a chance to rehabilitate the company and manage their debt to equity ratios. The Debt Laws Amendment Bill (2011) has addressed this issue by proposing an amendment to Section 9 of SARFAESI (2002) allowing an ARC to convert a portion of the debt into equity.

> **Recommendation 44:** Amend Section 9 of SARFAESI (2002) to allow the issue of convertible debt by an ARC. The proposals contained in the Debt Laws Amendment Bill (2011) allows converting only a portion of the debt into equity. It does not allow the conversion of all of the debt into equity, and it does not allow issuing convertible debt which may or may not convert into equity.

Restricted market: Currently only banks, public financial institutions and housing finance companies are allowed to avail of the privileges granted to creditors under SARFAESI (2002). Institutional lenders such as NBFCs, deposit or non deposit taking, cannot avail of the privileges under SARFAESI (2002), unless GOI notifies that a particular NBFC is a "financial institution" under SARFAESI (2002). This creates an unequal playing field, where banks and financial institutions are better of than NBFCs when it comes to recovery of debts. There is therefore merit in extending the privileges of SARFAESI (2002) to

other institutional lenders which are regulated by RBI as it would level the playing field (Raghuram Rajan Report, 2009).

> **Recommendation 45:** Suitably amend SARFAESI (2002) to allow all secured creditors who are regulated entities under the purview of the Act.

Powers of RBI: Section 12 of SARFAESI (2002) states the powers of RBI to determine policy and issue directions:

> *"(1) If the Reserve Bank is satisfied that in the public interest or to regulate financial system of the country* ***to its advantage*** *or to prevent the affairs of any securitisation company or reconstruction company from being conducted in a manner detrimental to the interest of investors or in any manner prejudicial to the interest of such securitisation company or reconstruction company, it is necessary or expedient so to do, it may determine the policy and give directions to all or any securitisation company or reconstruction company in matters relating to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy based on risk weights for assets and also relating to deployment of funds by the securitisation or reconstruction company, as the case may be, and such company shall be bound to follow the policy so determined and the directions so issued."*

The power given to RBI under SARFAESI (2002) is so broad that RBI can regulate the entire financial system of the country to its advantage under SARFAESI (2002). In the overall framework of FSLRC, the intention is to draft principles-based law:

1. Where regulators have only certain *enumerated powers* to ensure by ex-ante measures that rights and protections in law are maintained.

2. Which will contain principles that reflect the factors *that will inform the choice of powers* to be used by the regulator. The regulators can then issue principles based or rules based regulations *within the scope of these powers.*

The general principles of regulation of an ARC is micro-prudential oversight to ensure appropriate diversification of risks, ring-fencing of the

ARC from deposit taking entities, and an overall systemic risk oversight to ensure that the failure of one ARC does not lead to the failure of the overall banking system.

> **Recommendation 46:** Amend Section 12 of SARFAESI (2002) to list enumerated powers of RBI along with principles that reflect factors which will inform RBI of the choice of powers to be used.

15.2 Stamp Duty

Stamp duty is required to be paid at various stages of the acquisition and at the eventual disposal of a NPA by an ARC. SARFAESI (2002) does not specifically answer the stamp duty issue since the subject in question is a concurrent subject under the Constitution of India (1949).[18] which allows both the central and state government to enact legislation on the subject. Stamp duty may be applicable on:

1. Transfer of assets to the ARC.
2. Issue of security receipts by an ARC.
3. Further transfer/sale of the acquired assets by the ARC.
4. Decree for transfer of any charged assets in favour of the ARC or any transfer of security receipts by the holders of security receipts.

The Committee on Corporate Bonds and Securitisation (2005) recommends that the Central Government should consider establishing an appropriate institutional process to generate a consensus across the States on the affordable rates and levels of stamp duty on debt assignment, pass through certificates and security receipts. It also suggests that the stamp duty rate should not exceed 0.05 percent of face value of the debt per year (maturity) of the bond issue amount (across tenors), with a cap of 0.25 percent or Rs. 25 lakhs whichever is lower.

For example, the maximum stamp duty rate should be 0.25 percent ad valorem with a cap of Rs. 25 lakhs for a 7-year instrument. In comparison,

[18] *See* Entry 44, List 3, Schedule 7 of the Constitution of India.

current stamp duty rates for conveyance in Maharashtra are charged at ad valorem rates with no caps.[19]

Until there is a rationalisation of stamp duty rates on asset reconstruction transactions, the high transaction costs acts as a deterrent for the growth of this business model.

> **Recommendation 47:** While stamp duty laws are not within the purview of laws to be rationalised either under FSLRC or within the scope of the TOR of this WG, this WG recommends that there must be rationalisation of stamp duty laws in India. A possible solution could be the levy of transaction tax as opposed to stamp duty. The power to levy transaction tax lies with the Parliament and a transaction tax similar to that of goods and services tax may be introduced by abolishing stamp duty (IBA, 2012).

15.3 Recommendations to process clarifications

Recommendation 48: The recommendations in this part are primarily clarifications and standardisation of the process of securitisation, and are not features of the primary law. Reforms in these areas would lead to smoother functioning and greater clarity in the process of securitisation. Some of these also act as a guide to the enumerated powers/principles to be reflected in the powers of the regulator under Section 12 SARFAESI (2002):

1. **Clarity on sale/lease of business:** Although Section 9(b) of SARFAESI (2002) allows securitisation/reconstruction companies to sell or lease a part of the business of the borrower, the exercise of this power is subject to RBI guidelines, which have not been issued by RBI, refer to RBI (2012c). This WG recommends that since the primary legislation allows sale or lease of a business by an ARC, the regulator must not exercise discretion by not issuing guidelines on substantive rights.

2. **Restructuring support finance:** Borrowers' debts turn into NPAs on account of their inability to finance the debt. The goal of restructuring is to turn around the profitability of such borrowers. Typically, ARCs fund the purchase of the bad assets by

[19] Article 25, Schedule I, Bombay Stamp Act (1958).

issuing securitisation receipts to QIBs. ARCs are only allowed to deploy funds to restructure the loan account of the borrower. Deploying of funds by the ARC into the defaulting borrower is not permitted (RBI, 2003). Given that ARCs are in a better position to restructure and revive failing companies there may be merit in allowing ARCs to also deploy funds into the borrowing company. On the basis of the proposals contained in the Debt Laws Amendment Bill (2011), which allows partial conversion of loan into equity, deploying funds into the borrower company should be allowed, as this will act as an incentive for the ARC to restructure the company in a holistic manner. This WG is of the opinion that the regulator must prescribe guidelines, subject to prudential regulations, on when ARCs can deploy funds towards restructuring the borrower company along with the process to be followed.

3. **Pledged shares and exemptions from Takeover Code (2011):** When the underlying security, which has been acquired by an ARC, are shares held in dematerialised form, there are no statutory provisions or regulatory guidelines allowing substitution of the ARC in place of the original lender. This leads to complications and excessive procedural requirements. Further, while banks and financial institutions have been exempted from the Takeover Code (2011) for pledged shares held by them, similar exemptions have not been made applicable to ARCs (Committee on ARCs, 2011). This WG recommends that substitution of ARCs in place of the original lender, and the exemption from the applicability of the Takeover Code (2011) must be allowed. This would however require appropriate amendments to sub-ordinate legislation by SEBI and MCA, as applicable.

4. **Modification of charges:** Companies which mortgage their assets are necessarily required to intimate the ROC to assist in case of insolvency/winding up. However, currently dormant companies (companies who have not complied with filing of annual returns among other things) are not allowed to change or modify their charge registers in light of recent notifications of the MCA.[20] This leads to a situation where if the assets of the dormant company are securitised and transferred to ARCs, the names of ARCs

[20] The Ministry of Company Affairs through General Circular 33/ 2001 dated June 1, 2011 notified that unless a company files its updated balance sheet and profit and loss account it will not be able to file any event based compliance forms, including for modification of charges.

cannot be substituted leading to difficulties in enforcement proceedings/insolvency and winding up cases (Committee on ARCs, 2011). This WG is of the opinion that modification of charges and exemptions in case of ARCs acquiring NPAs of dormant companies must be allowed. This would however require appropriate clarifications by the MCA.

5. **Central Registry:** The Central Government has set up a central electronic registry under SARFAESI (2002) effective from March 31, 2011 to prevent frauds in loan cases involving multiple loans from different banks. The central registry is maintained by CERSAI under SARFAESI (2002). The registration of charges can be done online and search of the records of the registry can be done by any person online. This WG is of the opinion that the scope of the registry must be expanded to include encumbrance over any property and not just those which are mortgaged to banks or financial institutions. In addition all existing registration systems such as land registry and filings with the registrar of companies, must be integrated with the central registry so that encumbrance on any property (movable or immovable or intangible) is recorded and can be verified by any person dealing with such property.

Since the purpose of FSLRC is to write laws/ suggest amendments to existing laws, the recommendations in this Section 15.3 necessitate amending primary laws only to a limited extend, and require clarifications/guidelines through sub-ordinate legislation.

Acronyms

ADI Authorised deposit taking institution. 43

APRA Australian Prudential Regulation Authority. 44

ARC asset reconstruction company. 20–22, 75, 83–89

BCBS Basel Committee on Banking Supervision. 53

BNDES Brazilian Development Bank. 42, 43

Board Board of Directors. 6, 7, 10, 11, 35, 40, 41, 51–57, 106, 107

BOM Board of Management. 6, 7, 35, 106

BSM Bank subsidiary model. 12, 31, 58–61

CCI Competition Commission of India. 9, 41, 49, 50

CEO Chief Executive Officer. 7, 24, 35, 54, 55, 106, 108

CERSAI Central Registry of Securitisation Asset Reconstruction and Security Interest of India. 22, 89

CFSA Committee on Financial Sector Assessment. 38

DICGC Deposit Insurance and Credit Guarantee Corporation. 30, 64, 109

DRAT Debt Recovery Appellate Tribunal. 72, 78

DRT Debt Recovery Tribunal. 15, 17–20, 71, 72, 74, 78–82

EEA European economic activity. 34

FBO Foreign Banking Organisation. 44

FCA Financial Conduct Authority. 49

FDIC Federal Deposit Insurance Corporation. 31, 32

FHC Financial holding company. 8, 12, 15, 36, 57–62, 69

FSA Financial Services Authority. 43, 44

FSB Financial Stability Board. 52–54

FSLRC Financial Sector Legislative Reforms Commission. 4, 5, 7–9, 13, 14, 20, 35, 39, 45, 49, 67, 68, 77, 85, 87, 89

FSOC Financial Stability and Oversight Council. 44

G-20 Group of Twenty Finance Ministers and Central Bank Governors. 52

GOI Government of India. 8, 12, 24, 45, 79, 84

HMT Her Majesty's Treasury. 33, 43

IRDA Insurance Regulatory and Development Authority. 19, 81

MCA Ministry of Company Affairs, Government of India. 22, 88, 89

MD Managing Director. 10, 56

MOF Ministry of Finance, Government of India. 19, 51, 81

NABARD National Bank for Agriculture and Rural Development. 31

NBFC Non-banking financial company. 7, 27, 29, 30, 36, 38, 39, 47, 84

NHB National Housing Bank. 37

NMC National Monetary Council. 42

NOHC Non-operating holding company. 61

NPA non performing asset. 21, 22, 86, 87, 89

OFT Office of Fair Trading. 48

PSB Public sector bank. 4, 8–11, 24, 37–40, 43, 45, 47, 50–53, 55–57, 107

QIB Qualified Institutional Buyer. 21, 83, 88

RBI Reserve Bank of India. 6–9, 14, 20, 21, 24, 28, 29, 31, 34, 35, 37, 38, 40–42, 45–47, 51–54, 59, 64, 68, 73, 85–87, 105

ROC Registrar of Companies. 22, 88

RRB Regional Rural Banks. 9, 48, 50

SBI State Bank of India. 4, 9, 24, 37, 45, 48, 50, 106

SEBI Securities and Exchange Board of India. 11, 19, 22, 57, 81, 88

TOR Terms of Reference. 4, 5, 20, 87

UCB Urban Cooperative Bank. 6, 16, 35, 73, 74

UFA Unified Financial Authority. 7, 36

UK United Kingdom. 5, 24, 25, 27, 33, 43, 44, 48, 49, 77, 79, 80

USA United States of America. 5, 24, 25, 27, 31–33, 44, 49, 60

WG Working Group. 4–13, 15–17, 19–22, 30, 31, 34–36, 45–47, 49, 50, 55–57, 61, 62, 66, 67, 69, 72, 73, 76, 77, 80, 82, 87–89, 105

WOS Wholly owned subsidiary. 8, 45, 62

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A Expert committee recommendations

Expert committee reports have made recommendations concerning the key issues dealt by this WG. The major recommendations are set forth under the following broad issues:

1. Level playing field
2. Consolidation in banking and competition policy
3. Ownership, governance and compensation
4. Holding company structures
5. Debt recovery
6. Strengthening consumer protection, resolution and prudential regulation of banks

The main thrust of these recommendations is to improve financial intermediation and efficiency in the banking sector by increasing competition and reducing political and regulatory interference in bank operations.

Specific details on the recommendations of the Committees are given below:

1. **Level playing field**
   (a) Raghuram Rajan Report (2009)
      i. The Committee made a number of recommendations on ways to level the playing field, with a focus on the banking sector. The greatest source of uneven privileges in the banking system stems from differences in ownership. For example, government ownership automatically confers benefits as well as costs. The report affirms that there is little evidence to suggest that the ownership of banks makes any difference to whether they undertake social obligations.
      ii. Recognising that the opinion on privatisation of banks is divided the committee recommended intermediate steps such as reducing the governments ownership below 50 per cent while retaining its control.
      iii. To enable a level playing field, the committee recommended that the supervision of all deposit-taking institutions should be placed within RBI. The system of dual regulation of cooperative banks should cease. Though it involves constitutional issues, the system of shared responsibility should be overhauled.

iv. All financial intermediaries governed by special statutes should be governed by general statutes. These special statutes like the SBI Act, SBI (Subsidiary Banks) Act should be repealed, and statutory corporations should be corporatised or formed under the general statutes governing form of business enterprise such as the Companies Act, 1956 and placed on a level playing field with all other financial services intermediaries.

(b) Y H Malegam Report (2011): The Committee recognises that the system of dual control is one of the important factors responsible for the less than satisfactory performance of several UCBs. To deal with the problem of dual control, the Committee recommends the creation of a new organization structure for UCBs consisting of a Board of Management in addition to the Board of Directors. The Board of Directors would be elected in accordance with the provisions of the respective State Co-operative Societies Acts or the Multi-State Co-operative Act, 2002 and would be regulated and controlled by the Registrar of Co-operative Societies. The Board of Directors would establish a BOM, which shall be entrusted with the responsibility for the control and direction of the affairs of the Bank assisted by a CEO who shall have the responsibility for the management of the Bank. RBI would have powers to control and regulate the functioning of the Bank and of its BOM and of the CEO in exactly the same way as it controls and regulates the functioning of the Board and the Chief Executive in the case of a commercial bank.

(c) CFSA (2009) : The report states that while the problem of dual regulation of cooperative banks cannot be addressed due to constitutional issues, it can be partly addressed by separating the boards of the co-operative society and separating the regulation of banking business from the co-operative business.

2. **Consolidation in banking and competition policy**

(a) Narasimham Committee Report (1991):

i. Branch licensing should be abolished and left to commercial judgement.

ii. National treatment of foreign banks should be permitted to operate in India.

iii. The banking system should evolve towards : 3 to 4 large banks, including SBI which should become international 8-10 national banks engaged in universal banking Local banks operating in specific region Rural banks (including RRBs) primarily in agricultural credit.

iv. Moves towards revised system should be market/profitability driven and effected through M&As.

(b) Raghuram Rajan Report (2009):

i. The report recommends a more liberal approach in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks.

ii. The report recommends that banks should be free to set up branches and ATMs anywhere.

iii. The report recommends a favourable regime towards allowing entry to private well-governed deposit-taking small finance banks. The risk emanating from being geographically focussed can be offset by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a share of capital that can be made to one party).

(c) Percy Mistry Report (2007)

i. In the interest of improving competition policy, the opening of branches and ATMs by banks should be completely decontrolled.

ii. Permit entry by Indian corporates into banking.

3. **Ownership, governance, and compensation**

(a) Narasimham Committee Report (1991)

i. Banks should be free to make own recruitment policies.

ii. The report recommends the need for change in technology and culture and greater flexibility in personnel policies.

iii. The report recommends a depoliticisation of the appointment of Chief Executive for banks/DFIs

(b) Raghuram Rajan Report (2009)

i. Creating stronger Boards for PSBs: The process of appointing members on the Board of various PSBs must be through an independent selection board of eminently qualified individuals from varied backgrounds. The members of the selection board must retire at staggered intervals so that no future government can easily change its character.

ii. Shareholders nominees: Non-government shareholders must be allowed to appoint directors on the Board.

iii. Delegation: All decision making must be delegated to the Board of the bank.

4. **Holding company structures**

(a) Raghuram Rajan Report (2009)

   i. Allowing holding company structures, with a parent holding company owning regulated subsidiaries.

   ii. The holding company should be supervised by the Financial Sector Oversight Agency, with each regulated subsidiary supervised by the appropriate regulator.

   iii. The holding company should be well diversified if it owns a bank.

(b) Percy Mistry Report (2007) emphasises the holding company approach for reaping the economies of scope and scale by financial firms.

   i. On the structure, the report states that the holding company would be a listed company, with a corporate headquarter engaging in pursuing the business strategy of a unified financial conglomerate. The strategy would be executed by multiple subsidiaries through their respective CEOs.

   ii. The holding company must be required to comply only with the (Companies Act, 1956) and with exchange listing requirements if it is listed. It should not be subject to financial regulation by any regulator.

   iii. The subordinate legislation governing banks, insurance companies etc. should recognise 100% ownership in the hands of holding companies. These can have dispersed shareholding and public listing requirements along the lines applied to any other company in any other line of business.

   iv. The report highlights the need for a group tax regime. It stresses on the desirability to tax a group on the basis of its overall financial performance, incorporating the performance of all subsidiaries together.

   v. The report recommends revisiting the relevant provisions of the (Companies Act, 1956) that pose restrictions on leverage and intra-group transactions by the holding company structures.

5. **Debt recovery**

   (a) Narasimham Committee Report (1991)

      i. Special Tribunals need to speed the recovery of loan losses.

      ii. Following Narasimham Committee Report (1991): Recovery of Debts Due to Banks and Financial Institutions Act, 1993 was enacted.

6. **Consumer protection in banking**: Raghuram Rajan Report (2009) emphasises the need for adequate consumer protection. In interactions between

financial firms and unsophisticated households, stress should be on adequate disclosures and transparency on the terms of contract.

7. **Strengthening the resolution regime**
   (a) The Raghuram Rajan Report (2009) suggests implementation of a strong prompt corrective action regime so that unviable cooperatives are closed, and would recommend that well-run cooperatives with a good track record explore conversion to a small bank license, with members becoming shareholders.
   (b) The Committee recommends strengthening the capacity of the DICGC. The mandate should be broadened to include risk-assessment to resolve a failing bank, instilling a more explicit system of prompt corrective action and making deposit insurance premia more risk-based.

8. **Prudential regulation**: Tarapore Committee (2006): Given the importance of commercial banks in the Indian financial system, banking system should be the focal point for appropriate prudential policy measures. Prudential measures should be applicable to both balance-sheet and off-balance sheet items. A discussion on prudential regulation should encompass the following dimensions:
   (a) Regulation of specific and inter-related risks that arise from international capital flows.
   (b) Improvements in liquidity management and disclosure practises.
   (c) Improvements in corporate governance in public sector banks with the aim of ensuring operational autonomy.
   (d) Increased transparency and disclosures on risk exposures and risk management in banks.

B List of Acts

- Banking Regulation Act, 1949
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- Companies Act, 1956 (to a limited extent)
- Reserve Bank of India Act, 1934, rules, guidelines, master circulars, and regulations made thereunder
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

- Recovery of Debts Due to Banks and Financial Institutions Act, 1993
- FEMA Act, 1999 (for foreign currency dealings), guidelines, rules, regulations and master circulars made thereunder
- Banking Ombudsman Scheme, 2006 (not an Act, but governs resolution of consumer disputes)
- Payment and Settlement Systems Act, 2007
- Regional Rural Banks Act, 1976 (for rural banks)
- Deposit Insurance and Credit Guarantee Corporation Act, 1961
- Banking Laws (Amendment) Bill, 2011
- State Co-operative Societies Acts (for each state)
- Multi State Co-operative Societies Act, 2002
- Banking Regulation Act, 1949 (Part V)
- State Bank of India Act, 1955
- State Bank of India (Subsidiary Banks) Act, 1959
- Competition Act, 2002

C List of Committees Reports

- Narsimham Committee I and II
- Percy Mistry Committee
- Raghuram Rajan Committee
- Leeladhar report: Consolidation of Banking Industry in India
- Umarji Report: Review of the Banking Regulation Act
- A Ghosh Committee: Frauds and Malpractices in Banks
- Adhyarjuna Commitee :Changes in NI Act and Stamp Act
- B Eradi Committee: Insolvency and winding up
- Bhide committee: Coordination between commercial banks and SFC's
- James Raj Committee: Functioning of PSBs

- K Madhav Das Committee: Urban Co-operative Banks
- Marathe Committee: Licensing of New Banks
- ML Dantwala Committee: Regional Rural Banks
- Thingalaya Committee : Restructuring of RRBs
- SS Nadkarni Committee: Trading in PSBs
- SS Kohli: Rationalising Staff Strength in Banks
- S Padmanabhan Committee: Inspection of Banks
- S Padmanabhan Committee: Onsite supervision function of Banks
- RN Midgra Committee: Cooperative societies
- Rajamannar Committee: Changes in banking laws and bouncing of cheques
- Raghavan Committee: Competition Law
- R Jilani: Inspection system of banks
- Pillai Commitee: Pay scales of bank officers
- Pendarkar committee: Review of the system of inspection of commercial, RRB and urban co-operative banks
- Report of the Committee on financial sector assessment