Shyamala Gopinath: Changing dynamics of legal risks in the financial sector

Inaugural address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the Symposium on “Changing Dynamics of Legal Risks in the Financial Sector”, Kochi, 30 October 2009.

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It gives me great pleasure to be amidst you all today to inaugurate this Symposium.

At the outset, I may say that this Symposium on **“Changing Dynamics of Legal Risks in the Financial Sector”** could not have been organized at a more appropriate time than now. The recent global financial crisis has brought to light various risks. It has to a great extent blurred the distinction between operational risks and legal risks. As they say, each crisis opens up opportunities for learning and innovation; it is just the right time for the legal fraternity to put on their thinking cap and investigate which of the many risks that culminated in the crisis may be identified as legal risks and what legal steps could have been taken that would have mitigated its effects. Contextually in the wake of increased financial integration and globalization, it is essential that in-house legal officers also have an understanding of legal risks from a cross border point of view. I have no doubt that a Symposium like this in which heads of legal departments of various regulators, banks and financial institutions are participating where they will have an opportunity to interact with distinguished speakers having rich experience in the field, drawn from within the country and abroad, will provide a proper direction to identify and deal with legal risks.

As a central banker with three decades of experience I have had occasions to deal with diverse operational problems and difficult issues. I have no hesitation in saying that inputs received from the legal department of RBI have been very useful. At times one may feel that the legal opinion is a bit too rigid and conservative and fails to recognize the dynamics of the sector, but in the end we all need to appreciate that legal risks have to be accorded prime consideration and addressed.

What is legal risk?

There appears to be no concrete definition for the expression “legal risk” nor do I venture to make an attempt at defining it considering the complexities and variations in the risks involved. The Basel II accord covers “legal” risk under “operational” risk.

Legal risk may vary from institution to institution depending on the manner in which it conducts its business and the documentation it follows. The legal risks primarily arise either due to lack of clarity of the documentation of the product or the act of the counterparty. Change in legal environment due to legislative changes and Court interpretations/proceedings also result in legal risk. Legal risk includes risk of non-enforceability of contract or in-correct documentation resulting in the increased probability of loss. Broadly, legal risks may result in (i) claims against institution, (ii) fines, penalties, punitive damages, (iii) unenforceable contracts resulting from defective documentation, and (iv) loss of institutional reputation.

Documentation forms an important part of the banking and financial sector. For many, documentation is a panacea to the legal risks that may arise in banking activities. But then it has also been realized and widely acknowledged that loopholes exist in these documentations. As a result of lessons learnt from time to time, the loopholes in the documentation are attempted to be plugged by adding further terms and conditions in existing documents or by adding further documents resulting in voluminous and confusing documentation. In banking there is no end to innovation in documentation because, for keeping pace with the changing needs and aspirations of the customers, banks have been venturing into various kinds of innovative products. Identifying the legal risks that lurk behind modern techno-savvy complex transactions and market jargon, is no easy task.

The starting point while entering into any financial transaction is the legal capacity to contract and this becomes complex to interpret in respect of innovative financial instruments, since laws or regulators may not have kept pace with financial innovation.

The risk of loss due to non-enforceability of the contract in a court of law as one of the counterparties lacks the legal capacity to contract was witnessed in the case of Hammersmith & Fulham, UK. In this case, the city councils had entered into a series of interest rate swaps with banks, which turned out to produce major losses for the councils due to increase in British interest rates. The swaps were later ruled invalid by British Courts as the city councils did not have the authority to enter into such transactions and were found to be ultra vires. As a result, the loss had to be absorbed by the counterparty banks.

Lessons of the crisis

Some of the key legal risks faced by entities in the recent financial crisis related to bankruptcy risks, mis-selling of complex derivatives, enforceability of contracts/agreements backing OTC transactions across jurisdictions and the hitherto untested risks in the securities market – custodial arrangements, repo transactions, tripartite agreements, securities lending etc. Over the past few decades the rising complexity of financial markets and instruments had also engendered a parallel legal paraphernalia primarily to manage the counterparty risks. However, this was the first occasion that this support structure was put to real test internationally. I would like to briefly touch upon the key legal issues and lessons thrown up by the crisis in operations of different areas of the financial industry:

One of the key issues faced in many jurisdictions was the heterogeneity of resolution arrangements where the entity under bankruptcy proceedings had operations across many countries. Towards addressing the difficulties faced by regulators on this count, international efforts are underway for developing a homogenized resolution framework for entities having cross-border operations. A tricky issue in this regard is that a common resolution framework may be difficult to achieve given the diverse nature and difficulties in carrying out legislative changes since each jurisdiction will want to protect its domestic interests.

The crisis also highlighted the issue of sharing of information among regulators. Countries have different arrangements for sharing such information. This becomes more onerous when it comes to sharing of information with overseas regulators. As countries become more globalised the regulators may have to consider arrangements to share appropriate and relevant confidential information of regulated entities with other regulators subject to conditions and safeguards within the individual countries' political and economic circumstances.

Huge derivatives losses faced by corporates in many countries has clearly underlined the need for sound contractual agreements between the banks and clients. More than that, it has highlighted the need for the providers of service, particularly banking services, to have a more responsible approach. Banking as a concept essentially rests on trust and confidence and no amount of legal remedies can substitute these.

The crisis has also brought to the fore the importance of sound legal agreements with all counterparties, particularly brokers and other intermediaries in forex and securities markets, which essentially act as agents. It is essential to ensure that these intermediaries are regulated in a regime with specific provisions to ensure segregation of assets. The same risk applies to global fund managers where it is a 3-tier structure with the fund manager further having a link with the brokers. It is better to have some guidelines/oversight on the type of broker relationships that the fund manager can enter into.

It is important to ensure that the collateral rights are enforceable under the relevant law and that the agreements provide for keeping collaterals out of the bankruptcy provisions – in case of bankruptcy, the bankruptcy administrator has the discretion to decide which obligations to enforce and which ones to write off after close out netting – if collaterals are part of the closeout netting, then there may be a possibility of write offs as part of bankruptcy proceedings.

The crisis has also underlined the risks inherent in re-hypothecating assets. Where assets are re-hypothecated, they are at best difficult to identify and extract in the event of bankruptcy. At worst, the assets may never be located, leaving clients to stand in line with other creditors to try and get their assets. Perhaps this is a challenge to the legal mechanism to protect the interest of the original holders. This highlights the flaws in the co-mingled account model also. Assets held in co-mingled accounts can be difficult to identify if the prime broker fails, leaving administrators with the task of identifying which assets belong to which clients. Some suggest the use of the tri-party collateral management model in which a third party sits between the prime broker and their hedge fund or other clients holding the collateral in segregated accounts. However, concentration of such repos with only few banks aggravates systemic risk.

I would like to cite another instance of issues regarding re-use of collaterals. In one case a bank entered into Equity Finance[1] and Standard Securities Lending arrangements with a number of brokers. The securities lent to the bank by brokers were generally obtained as a result of the Equity Finance arrangements between the brokers and their clients. However, after the collapse of one of the brokers there was dispute about the ownership of securities highlighting the loopholes in the agreement entered.

Indian experience

Though the financial services industry in India is of a relatively recent origin, there have been many tricky legal issues that the industry has faced over the years.

I would like to refer to one of the early instances where the legality of a market product, ready forward transactions, was decided by the Supreme Court in a landmark judgement.

Ready-forward (repo) transactions were quite popular in the market in the eighties. But immediately after irregularities in Indian capital markets in early nineties, the legality of this product was challenged. The Supreme Court of India[2] held that ready forward contract is severable into two parts, namely, ready leg and forward leg. It further held that the ready leg is valid but the forward leg is not. Therefore all the repo transactions were treated and accounted as outright sale and purchase transactions. The lending and borrowing nature of repo transactions has now been captured in the amendment to the Reserve Bank of India Act carried out in 2006 by defining repo and reverse repo transactions.

Another issue is related to legal validity of OTC contracts. Since derivative transactions may be regarded as contracts for differences, they could be regarded as wagering in nature, when cash settled. However, under section 18A of the Securities Contracts (Regulation) Act, 1956, derivatives traded on a recognized stock exchange and settled on the clearing house of the recognized stock exchange are valid. The uncertainty with respect to the validity of

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[1] Equity Finance is a form of Securities Lending where the value of the transferred securities is more than the value of the cash received in exchange.

[2] B.O.I Finance Ltd. v. Custodian and others, (1997) 10 SCC 488.

OTC derivatives was removed by amendment to the Reserve Bank of India Act carried out in 2006 providing for validity of OTC derivative contracts in certain cases.

Certain legal challenges faced by banks in India

During the Financial Sector Assessment Program jointly undertaken by he Government of India and Reserve Bank, it was found that insolvency matters take on an average of ten years for resolution. An instance of a court decision posing serious ramifications to the business of banks was recently seen when the Gujarat High Court held that sale of non performing assets by one bank to another is not a permissible form of business for banks. Though the matter is now before the Hon'ble Supreme Court, considerable time may be lost. Similarly, amendments made by certain States according priority to the dues of State over those of the secured creditors and the recent decision of the Supreme Court holding that such State claims would have predominance, has been highlighted by the banks as posing a significant legal risk to them. The fact that even security interests created prior to the crystallisation of State dues are not getting priority is a matter of grave concern for the banking sector. The absence of a single point database for verification of security interests created by banks/FIs accentuates the legal risk in security interest creation.

Another area where banks are increasingly exposed to legal risk is the rising consumer grievances about the services rendered by the banks. Many a time, the lack of the awareness among customers about the niceties of the innovative products offered by the banks leads to customer grievances and resultant litigations. In order to tide over legal risks, some of the banks have been incorporating suitable clauses in the agreements which make the terms therein tilt in their favour. It is not possible to predict how the courts would treat these clauses, if challenged by the customers as unconscionable. This makes it imperative that the contracts governing such innovative products clearly exhibit fairness in the terms and conditions and are transparent with adequate disclosures and not one sided contracts.

Even though outsourcing of certain activities, by banks has helped customer service, banks have to address the legal risks that may arise owing to breach of confidentiality or any fraud that may be committed by their agents as banks would be liable for their acts and omissions including any misrepresentations to the customers and breach of any law committed by the service providers.

Legal reforms initiated by RBI

The RBI has been initiating amendments in law to keep pace with the dynamic market place.

(i) The enactment of the **Payment and Settlement Systems Act, 2007** providing, inter alia, for settlement finality and netting, is a very big step in ensuring settlement finality resulting from multilateral netting. The settlement that has become final and irrevocable under this Act will not be affected by the passing of the order of adjudication or dissolution or winding up under other laws including Companies Act, 1956 and Banking Regulation Act, 1949.

(ii) Amendments to the **Reserve Bank of India Act** providing for validity of certain OTC derivative contracts which I referred to earlier.

(iii) The amendments to the **Negotiable Instruments Act** providing for electronic cheques and cheque truncation.

(iv) The **Information Technology Act** providing for recognition of digital signatures and consequent amendments to the **Indian Evidence Act, Bankers' Books Evidence Act** are some of the recent initiatives undertaken in India.

But there are still issues which are left to be addressed like cross border insolvency issues, jurisdictional issues in cross border transactions etc., which would require a concerted effort from the international community. It is advantageous to refer to the recommendations of the Committee on Financial Sector Assessment in this regard. Some of the legal reforms suggested by that Committee are,

(1) Enactment of the UNCITRAL Model Law on Cross Border Insolvency with modifications suitable to India's needs,

(2) Conferring statutory priority to the claim of banks and financial institutions in respect of the financial assistance given to rehabilitate a sick/weak company in financial distress,

(3) Extension of such priority of claim even while disbursing the assets in liquidation,

(4) National Company Law Tribunal (NCLT) to be made functional for any significant improvement in the restructuring process,

(5) Extension of SARFAESI Act to cover security interest in Agricultural land beyond a specified holding (for eg. 5 Acres).

(6) insertion of Section 29A in Banking Regulation Act empowering Reserve Bank to call for information and returns from the associate enterprises of banking companies and inspect the same, if necessary.

(7) Setting up of the Central Registry urgently to have a central and reliable record of all security interests created by banks and financial institutions and other entities/individuals in respect of both immovable and movable property by a separate legislation in respect of the Central Registry.

Legal risks for the regulators

I am sure that you would acknowledge that life of Central Bankers and regulators is not enviable either. Regulators also face legal risks. In addition to being exposed to the legal risks arising out of international contracts entered into as part of their own operations between banking regulators inter se and the risks arising out of domestic contracts such as derivatives entered into with regulated entities, regulators run the risk of the regulatory measures taken by them for disciplining the errant entities being quashed by the Courts.

Our experience is that customers filing suits/complaints in courts and consumer fora implead RBI as a party to the case for failing to enforce its circulars. The track record of RBI (and by implication the legal department) in this regard has been very good. Right from the 1962 decision of the Supreme Court in Palai Central Bank case upto the 2007 decision of the Supreme Court in the case of Ganesh Bank of Kurundwad, the action taken by RBI has been upheld.

However, the point is that the exercise of statutory powers by the regulators is not immune from judicial scrutiny. The regulator is expected to act strictly within the four corners of law. The regulator should ensure that the decision making process is fair, bonafide and reasonable and the decision is in accordance with law. Any dilution of these standards exposes the regulator to legal risk which has far reaching consequences on its credibility.

Some financial transactions or products introduced by financial intermediaries may fall within the domain of more than one regulator. There is a need to have a clear, effective and smooth co-ordination among the regulators to deal with issues relating to regulatory arbitrage, tax arbitrage etc. In India the High Level Co-ordination Committee comprising Members from RBI, SEBI, IRDA etc. provides an effective platform facilitating coordinated action.

Role of in-house lawyers

In the present day, the role of in-house lawyers has changed considerably. They can no longer confine to their traditional role of giving legal advice keeping themselves aloof from the business requirements of the institutions. The role of an in-house Lawyer becomes most prominent as they are best equipped to identify and assess “legal risks”. Their specialized knowledge and familiarity with the institutional policies enable them to perform this function. The in-house lawyers need to understand the business processes and the transactional intricacies to assess legal risk. They are expected to apprise the management the nature and extent of “legal risks” and help the management to take a well informed commercial decision. To achieve this, in-house lawyers should not hesitate to obtain access to all relevant information and should involve themselves in the decision making process of the institution in a proactive way. They should also have sufficient independence and a separate reporting line to the top management in the organizational structure.

Concluding remarks

Perhaps the bottom line in the area of legal risk management remains on the choice of counterparty and the understanding of the legal documents. The understanding of legal documents should be crystal clear without any scope of ambiguous interpretation and match with the requirements and objectives of the parties concerned. Due diligence during the process of preparation of the legal documents is actually put to rigorous test only during periods of crisis. At times of crisis/distress, not only the aggrieved party looks at the legal recourse for remedy, the defaulting party also looks at legal loopholes to get out of the liabilities arising out of the transactions or atleast delay the settlement process.

In the light of various developments in the fast changing financial markets during the recent crisis, the importance of Legal Audit in all financial institutions cannot be overemphasised. The objective of the legal audit could be to review the various agreements with the custodians, counterparties, service providers, etc. The coverage of the audit could include all the agreements, the legal title to the foreign assets, liabilities under various laws. Thus, legal audit is a health check of the level of risk that can arise due to insufficient or inappropriate documentation or lack of understanding acts of a foreign land. The legal audit is a means of identifying legal risks and suggesting course correction for smoother sails during crises.

These are some of the thoughts which I felt were relevant to this Symposium organized by the Legal Department of RBI in the Platinum Jubilee year of RBI. I have quickly run through the articles contributed by the participants which are included in the reading material distributed to you and find these very educative and extremely valuable and very important points have been raised and well articulated arguments have been made. I am sure this Symposium will prove to be fruitful for all of us.

With these words, I formally inaugurate this Symposium and wish it all success.

Thank you.