Anand Sinha: Legislative reforms – strengthening the banking sector

Address by Mr Anand Sinha, Deputy Governor of the Reserve Bank of India, at the Financial Planning Congress'11, organised by the Financial Planning Standards Board of India, Mumbai, 18 December 2011.

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Justice (Retd.) Shri B.N. Srikrishna, Chairman, Financial Sector Legislative Reforms Commission (FSLRC), Shri Swarup and Shri Malegam (members of FSLRC), Shri Yogesh Agarwal, Chairman, Pension Fund Regulatory and Development Authority (PFRDA), Shri Mudholkar and Shri Chikermane, and other delegates. It is an honour and privilege for me to address you today, on some of the key issues with regard to "Reforms in the Banking Sector" and I thank Financial Planning Standards Board of India for this opportunity. This Financial Planning Congress comes at a very opportune time when the far reaching exercise of rewriting financial laws is being undertaken by the FSLRC and I commend the organisers for their efforts in putting together this Congress.

I. Introduction

Empirical research shows that better developed financial systems accelerate economic growth and shrink income inequality by disproportionately increasing the earnings of lower income families[1] i.e. enabling growth with equity, which is so vital for our country. A well developed financial system will require sound legislative framework because, legislation is the foundation on which institutional frameworks stand. To be effective, legislation not only needs to be unambiguous and fair but also should be robust enough to address all the existing concerns while, at the same time, being flexible enough to accommodate the new needs on account of evolving environment.

Role of legislation in the context of economic development in general and the financial sector in particular, is an interesting area of study. It has been argued that strong legal systems foster development of sophisticated financial markets and intermediaries[2], which enhances the economy's ability to manage risk and eventually lead to economic growth. Measures such as robust contract enforcement and disclosure discipline go a long way in strengthening the financial systems.

Every legislation has a time dimension and its relevance has to be seen vis-à-vis this dimension. With the changing environment, practices and processes change, necessitating a review of extant legislations. This holds all the more true for an area like financial system where changes are rapid and frequent. The dynamic nature of legislation was well articulated when Aristotle said "*Even when laws have been written down, they ought not always to remain unaltered*".

India is said to be one the most over-legislated countries. We have numerous Acts and regulations, some of which date back decades. As times have changed quite significantly since they were enacted, there is an emphatic need to update and fine tune them so as to enhance their relevance for the rapidly changing financial landscape. It is a welcome step

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[1] Levine, Ross.

[2] Levine, Ross; Law, Finance and Economic Growth; Journal of Financial Intermediation 8 (1999).

that FSLRC has been constituted to look into and revise the existing financial legislation. In this context, the role of this Congress is very important in facilitating deliberations.

Financial sector policies comprise a set of policies, such as:

– Prudential policies to ensure safety and soundness of the financial system (financial stability)

– Regulatory and Supervisory policies

– Depositor and Consumer protection policies

– Financial Inclusion policies

– Other policies for ensuring adequate supply of credit to economically important sectors i.e. SMEs, Infrastructure, etc. and

– Market structure and Competition

Prudential policies comprise macro prudential and micro prudential policies aimed at ensuring the safety and soundness of the financial system. Collectively, both macro and micro prudential policies ensure the stability of the financial system which would facilitate efficient allocation of resources to the real economy. While financial stability is a necessary condition to ensure other objectives of financial sector policies as well as for growth and macroeconomic stability, it is not a sufficient condition to attain these objectives. Other financial sector policies will have to be implemented for balancing numerous considerations such as growth imperatives, flow of credit to disadvantaged and preferred sectors, consumer protection, financial inclusion and equity, etc. At times, it becomes extremely challenging to balance these considerations and, if adequate care is not taken in designing and implementing the other financial sector policies, financial stability may be adversely affected. Therefore, it is important that a set of sound financial sector policies (including prudential policies) backed by sound legislation must be adopted to deliver the various objectives – growth with equity in the backdrop of financial stability.

II. Recent amendments carried to various financial sector laws

Before I delve into some of the key issues requiring legislative review, I list some of the enactments and amendments that have been made to the various Acts during the last decade to highlight the dynamic nature of legislation.

i. Reserve Bank of India Act, 1934 was amended in 2006 to provide legality to certain OTC derivative transactions and also to give explicit regulatory powers to Reserve Bank over derivatives and money market instruments.

ii. The Banking Regulation Act, 1949 was amended in 2007 for removing the lower limit prescribed in maintenance of Statutory Liquidity Ratio (SLR) by banks and conferring wide powers on RBI in stipulating the SLR requirements for banks and to control liquidity in the market.

iii. The State Bank of India Act, 1955 was amended in 2007 for enabling transfer of ownership from RBI to Government of India and again in 2010 to provide for enhancement of capital, issue of preference shares, raise capital by public issue or preferential allotment or private placement or rights issue; and to issue bonus shares to the existing shareholders, etc.

iv. The State Bank of India (Subsidiary Banks) Act, 1959 was amended in 2007 to facilitate enhancement of capital, raise resources from the market and raise capital through rights issue.

v. The Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980 were amended in 2006 to enable nationalised banks to issue preference

shares in accordance with the guidelines framed by the Reserve Bank and to raise capital by preferential allotment or private placement or public issue, with the approval of the Reserve Bank.

vi. The Negotiable Instruments Act, 1881 was amended in 2002 to introduce the concepts of "electronic cheque" and "cheque truncation" by expanding the definition of "cheque".

vii. The Securities Contracts (Regulation) Amendment Act, 2007 was passed with a view to providing a legal framework for enabling listing and trading of securitised debt instruments, including mortgage backed debt.

viii. The Government Securities Act, 2006 was enacted to consolidate and amend the laws relating to Government securities and its management by the RBI. The Act simplifies the procedure for settlement of claims of legal representatives, provides for admissibility of computerised information as evidence, contains provisions for effectively dealing with misuse of Statutory General Ledger (SGL) accounts and facilitates pledging and hypothecation of Government securities.

ix. The Payment and Settlement Systems Act, 2007 was enacted empowering the Reserve Bank to regulate and supervise payment and settlement systems of the country and provides a legal basis for multilateral netting and settlement finality.

x. The Prevention of Money- Laundering Act, 2002 was enacted as a follow up to UN General Assembly resolution in 1998, calling for adoption of national anti-money laundering legislations and programmes by member states. The Act provides for preventing money laundering and connected activities, enables confiscation of proceeds of crime, setting up of agencies and mechanisms for co-ordinating measures for combating money laundering, etc.

xi. The Foreign Contribution (Regulation) Act (FCRA), 2010 was enacted by repealing the erstwhile Foreign Contribution Regulation Act, 1976 mainly to rectify several deficiencies found in the previous Act. The new Act covers the electronic media and organizations, other than political parties, apart from entities in the prohibited list in FCRA, 1976.

xii. The Credit Information Companies (Regulation) Act, 2005 empowers the Reserve Bank to regulate the Credit Information Companies (CIC) and to facilitate efficient distribution of credit and matters concerned or incidental to it.

III. The road ahead: legislative reforms in the banking sector

Multiple acts – need for consolidation

Banks are regulated and supervised under the Banking Regulation Act, 1949. Public Sector Banks viz., State Bank of India, State Bank of India subsidiary banks and Nationalized Banks which are constituted under different statutes are governed by their respective statutes and by some of the provisions of the Banking Regulation Act. The provisions relating to the ownership and management of banking companies as contained in the Banking Regulation Act are not applicable to the public sector banks. Co-operative Banks are constituted by the respective State Co-operative Societies Acts or by the Multi-State Co-operative Societies Act and the provisions of Banking Regulation Act are made applicable to them with certain modifications.

Since the origins of the banks have been historically different, they continue to be governed by the respective statutes as well as other general laws. Each of the statutes was crafted in a contemporaneous setting, reflecting the needs and concerns of the time. Therefore, almost

all the statutes were amended from time to time to reflect changes in circumstances and context prevailing at that time.

There is a strong case for reviewing these legislations and recasting them for a number of reasons. First, prudential regulations are ownership neutral. However, the fact that different banks are governed by different laws has resulted in an uneven playing field which needs to be addressed. For example, while amendments were carried out to enable SBI, SBI subsidiary banks and nationalised banks to issue preference shares, though at different points of time, banks in private sector cannot issue preference shares as the amendments to the BR Act is still to be carried out. Similarly, while bilateral netting in the event of liquidation is admissible for private sector banks governed by the Companies Act and the normal bankruptcy laws, the position in this regard for public sector banks, SBI and its subsidiaries is not clear in law, as liquidation, if at all, of such banks would be as per the Notification to be issued by the Government in this regard. Second, a single, harmonized and uniform legislation applicable to all banks will provide transparency, comprehensiveness and clarity and provide ease of regulation and supervision to the Reserve Bank. Third, there is also a need to sort out the conflicts and overlaps between the primary laws governing the banking sector and other applicable laws. For example, the Competition Act, 2002 (as amended by the Competition (Amendment) Act, 2007) is in conflict with the provisions of the Banking Regulation Act, SBI Act and other statutes dealing with the amalgamation of banks. Consolidation of banking sector laws and laying down of common regulatory framework for commercial banks are issues requiring serious consideration.

Management of banks

Management of banking institutions by *fit and proper* persons plays an important role in securing the safety of banks. While RBI has power, under certain circumstances, to remove the managerial and other persons from the banks and appoint additional directors, etc., these powers may not be effective in handling a situation where supersession of the Board is warranted. RBI, currently, does not have the power to supersede the Board of Directors of a banking company. In the Banking Laws Amendment Bill, 2011 amendments are being proposed for conferring such a power on RBI, for being used with appropriate safeguards. With respect to public sector banks, by way of amendments, similar powers have been vested in the Central Government, which has the majority shareholding in those banks.

The shareholding pattern also plays a vital role with respect to the management of banks and, therefore, it is necessary that shareholders having sizeable holding should also be fit and proper. RBI has, by way of regulatory prescriptions, implemented an acknowledgement procedure. In the 2011 Bill, statutory provisions are being proposed for obtaining prior permission of RBI for acquiring 5% or more of the equity shares or voting rights in a banking company. At present, a deadlock situation arises if a group of persons acquires sizeable equity or voting rights in a bank without following the acknowledgement procedure. There is no statutory power for directing disgorgement of shares and as such, if any such acquisition takes place, it may result only in contravention in provisions of BR Act. The main object of preventing the management of a bank from being captured by persons who are not fit and proper for holding such sizeable interest will not be achieved. RBI should, therefore, have the power to direct, by order, at any time that persons who are not fit and proper to hold such equity or voting power in contravention of these provisions, shall not have voting power. The 2011 Bill proposes to confer such power on RBI. This will help prevent unscrupulous persons from exercising control over banks.

Deposit collection activity

Currently, collection of deposits from members/shareholders is not treated as acceptance of public deposits. This is a matter of serious concern, particularly, with respect to Co-operative Societies. Deposits are accepted by enrolling members on tap and by collecting nominal

amounts from them, exposing such depositors to serious risks. Banking Regulation Act does not apply to such co-operative societies and they are outside the regulatory purview of the Reserve Bank. It is necessary to plug this important loophole. Unless deposits are received from members who have voting rights, the deposits have to be treated as public deposits and the exemption from the provisions of Banking Regulation Act should not be made applicable. Every entity that accepts deposits from persons having no voting rights has to be treated as deposit accepting entity and should be regulated as such by RBI. RBI should have the discretion to determine the level and intensity of regulation and supervision depending upon the risk to the system from such entities.

Financial conglomerates

In India, banks are entitled to carry on certain financial activities under the bank subsidiary model. Some banks have formed subsidiaries to carry on securities and insurance business. The performance of the subsidiaries affects the balance sheet of the bank. On account of varied activities carried on by the entities in the group which fall within the regulatory jurisdiction of multiple regulators, the risk to the system as a whole posed by such financial conglomerates is difficult to assess. These raise systemic issues and RBI as the regulator of banks needs to be empowered to obtain information, with respect to each of the entities functioning under the umbrella of a bank. The 2011 Bill proposes to confer such powers on RBI to get information with respect to such entities. This ought to be pursued in the new legislative framework also.

Non-operative bank holding company

The traditional theories of *economies of scale* and *scope* support bigger entities. In India, we need bigger banks to finance our very large infrastructure needs and also large industrial projects. Thus, while there are advantages in growing big and handling multiple activities, nobody knows where exactly the tipping point is, when the bigness of size starts becoming a disadvantage. The crisis has highlighted the downside of having “Too Big to Fail” entities. Very big and complex entities pose supervisory issues to the regulators and pose serious systemic risks. So we need to ensure that structures are not complex and that there are effective resolution mechanisms to ensure orderly winding up of these systemically important entities, in case of crisis.

It has been suggested that a non-operative bank holding company structure may be useful to deal with financial conglomerates as this greatly mitigates the risks spilling over from other entities in the Group. While the functional regulator of each subsidiary of the non-operative holding company may regulate and supervise the business of the subsidiary concerned, the non-operative holding company needs to be regulated on the lines of a bank and needs to be placed under the regulatory and supervisory control of RBI. Appropriate legislative measures are necessary for operationalising this model.

Apart from the regulatory issues in the above model, there are other challenges to be addressed. One of them is related to placing public sector banks under such holding companies. Another is the impact of taxation on the transfer of shares of the subsidiaries to the holding company. Unless adequate tax relief is granted, it will be difficult for existing banks to come under the holding company structure.

Stamp duty issues

In India, there are certain issues with respect to stamp duty on documents. One of the major hurdles facing the development of the securitisation market is the stamp duty structure. It can add up to a substantial cost as there are differentiated duty structures in different states. While some states have recognised the special nature of securitization transactions and

reduced the stamp duties, other states still operate at stamp duties as high as 5% to 12% for transfer of secured receivables.

Concerns about stamp duties have also been raised in the context of the proposed subsidiarisation of foreign banks. The broader objective of proposed subsidiarisation of foreign banks is to promote financial stability in India and this requires harmonisation and simplification of stamp duty structure across the country.

Minimum capital requirements

The minimum capital prescribed in the Banking Regulation Act for banks is too low and Reserve Bank is prescribing the minimum capital requirement in case of private sector banks from time to time (currently banks should have a minimum networth of Rs. 300 crores). Minimum capital requirements prescribed under the "Ownership and Governance" guidelines and that prescribed/ being prescribed for new banks in private sector are way above the current provisions of the Act. It would, therefore, be more appropriate to empower Reserve Bank to stipulate the capital requirements and other quantitative parameters from time to time, instead of prescribing quantitative limits in the respective Acts.

Migration to IFRS

As part of the efforts to ensure convergence of the Indian Accounting Standards (IAS) with the International Financial Reporting Standards (IFRS), the formats of financial statements will undergo changes consequent to the introduction of IFRS. Further, whenever banks introduce new types of capital instruments, etc. these will have to be appropriately incorporated in the format. Therefore, Reserve Bank should be empowered to prescribe the format of the balance sheet, profit and loss account, etc. given in Third Schedule of the B. R. Act.

Bilateral netting issues

Various banks had requested RBI to allow bilateral netting of counterparty credit exposure, in respect of interest rate and foreign exchange derivatives, and gold. The legal position regarding bilateral netting is not unambiguously clear in case of banks established by special statutes [like SBI Act, Banking Companies (Acquisition and Transfer of Undertakings) Act, etc.]. Amendments to a large number of enactments particularly in a synchronised manner may be practically difficult. Enacting a single legislation which covers all aspects of banks' functioning, while possibly providing differential legislative framework for corporate governance issues on account of ownership differences may make the legislative framework more efficient.

Bank resolution

The significance of effective resolution mechanism for promoting financial stability as well as consumer protection cannot be underestimated. The legal framework should address the resolution mechanism from a practical point of view and must have at least the following characteristics:

- Early intervention before insolvency
- Speed of intervention/resolution
- Ability to transfer or merge operations
- Effective write-down of shareholders' rights
- Protection of on-going business

In addition to banks, the resolution mechanism should address resolution of other Systemically Important Financial Institutions (SIFIs) also. Post crisis, globally, there have been initiatives to strengthen the resolution framework of Financial Market Infrastructures (FMIs) and other entities in the financial sector. The resolution mechanism should also include a framework for resolution of NBFCs and entities operating payment systems. Swift and simple procedure for quick resolution, particularly, that of systemically important entities – global and domestic, is necessary. Under the evolving international framework it would be required of jurisdictions, to have adequate resolution framework as per international standards. The key attributes of Effective Resolution Regimes were adopted by the Financial Stability Board (FSB) Plenary and endorsed by G-20 leaders at the Cannes Summit and these are an essential component of the package of policies to reduce the risks of moral hazard and the potential for systemic disruption associated with Systemically Important Financial Institutions (SIFIs). This will require legislative changes and administrative actions.

The powers of RBI for effective resolution of regulated entities from this perspective need enhancement.

Mergers

Voluntary mergers and transfers help consolidation in financial sector and pave the way for stronger financial institutions to rescue the weaker ones. Such voluntary measures, while saving the constituents of weaker institutions, provide business opportunity to the stronger ones to spread their presence in different geographies. The BR Act empowers RBI to sanction a scheme for voluntary amalgamation of banking companies. However, such a power is not available with respect to cooperative banks. Considering the challenges faced in quick resolution of failed cooperative banks, certain enabling provisions in the BR Act facilitating RBI to sanction a scheme for takeover of banking assets and liabilities of a cooperative bank by commercial banks would be desirable. Partial merger of certain businesses or assets and liabilities of banks also may need to be examined.

One of the issues that could complicate the resolution of banks through mergers and transfers due to the sensitivity of the process is the applicability of competition law. An enterprise proposing to enter into a combination via a merger or an amalgamation is required to notify the Competition Commission, and the Commission has been allowed up to 210 days to decide on it before the default clause kicks in. The 2011 Bill tries to address this issue.

Consumer protection and globally compatible secrecy laws

For speedy redressal of consumer grievances, RBI has framed the Banking Ombudsman Scheme by statutory directions under the BR Act. The Scheme is working satisfactorily.

Secrecy of customer information is a principle of common law which is practiced in India also by banks, and recognized by courts. Statutory basis for this has to be provided, by clearly setting forth the exceptions relevant to the present requirement of preventing money laundering and cross border financing of undesirable activities. The law should strike a balance between the privacy rights of the customer and the need to share crucial information with law enforcement agencies and other regulators, both domestic and foreign. In matters of crime and proceeds of crime, the larger public interest would outweigh the private interests of individuals. Appropriate amendments may have to be carried out in the BR Act to provide a statutory backing for the banking secrecy laws and the limits on the privacy of customers should be laid down.

Protection is required in the law to the regulators with respect to the information collected from the regulated entities including its assessment and analysis made by the regulators or supervisors and the correspondence related to such information.

In larger public interest, the law should enable sharing of information with other regulators, both domestic and overseas, for mutual benefit. The recent crisis has demonstrated the need

for such cooperation. The absence of specific protection to the information held by the regulators whether collected from the regulated entities or from other regulators impedes sharing of information. Our laws have to be globally compatible and specific exemption from disclosure needs to be provided in this regard. Disclosure of sensitive information could compromise the effectiveness of regulation and supervision. Further, unless the secrecy laws in our jurisdiction are compatible with global standards, it will not be possible to receive from, or share information with, overseas regulators. Appropriate provisions may have to be inserted in the RBI Act and the BR Act in this regard.

IV. Conclusion

Financial sector is a very important segment of the economy and has direct bearing on growth and prosperity. Strong financial systems need strong legal systems which provide unambiguous and fair legislation. The financial system in India including banking, insurance, capital, taxation, etc. has many regulators, each having a separate mandate. This blend raises pertinent concerns. First, financial system is still characterised by considerable fragmentation of legislation, regulation and enforcement. Second, policy related frictions might arise from the diversity of different legislations and the overlapping of the regulatory jurisdictions. Third, there might be a risk of legal arbitrage among financial jurisdictions.

A need has been continuously felt to rewrite and streamline the financial sector laws, rules and regulations and to bring them in harmony with the requirements of India's fast growing financial sector. The current legislations were drafted in the contemporaneous setting and have had to be amended from time to time to incorporate changes in the milieu. Enacting new law or amending old law is a continuous process to remain aligned to changing circumstances. In the emerging scenario, the task of preventing financial risks has become more important and challenging. Amid global economic worries, this is an enormous task which, on completion, would immensely benefit the financial sector in India and economy at large. A sound legal framework may help deter imprudent risk-taking by financial institutions and reduce systemic risks. Revision of banking sector laws should also be motivated by the recognition that the banking sector has been and remains a critical factor not only for accelerating India's growth but also for making it inclusive. Harmonising of financial sector legislations, rules and regulations has, therefore, become imperative. I have tried to give my views from regulatory and financial stability perspective. I hope you all will benefit from today's discussions.

Thank you.