CHAPTER 3

Existing Resolution Regime for Indian Financial Institutions

Brief Overview of FSB Key Attributes

3.1 The Financial Stability Board (FSB) has proposed a set of twelve core elements viz. the Key Attributes, as essential components of an effective resolution regime for financial institutions. These Key Attributes call for an effective "Resolution Regime" to be in place in all jurisdictions that provides the resolution authority with a broad range of powers/tools and options to resolve a firm that is no longer viable and has no reasonable prospect of becoming so. As per FSB, a systemically important financial institution is 'resolvable' if it is feasible and credible for the resolution authorities to resolve it without losses to taxpayers on account of solvency support, while protecting vital economic functions. For resolution to be feasible, the authorities must have the necessary legal powers – and the practical capacity to apply them – to ensure the continuity of functions critical to the economy. For resolution to be credible, the application of those resolution tools would not itself give rise to unacceptably adverse broader consequences for the financial system and the real economy.

3.2 The twelve Key Attributes that are expected to be part of the resolution regimes of all jurisdictions relate to the following:

(i) **Scope** - A resolution regime should necessarily cover all financial institutions that are systemically significant or critical if it fails and should also extend to the holding companies of a firm, non-regulated operational entities within a financial group or conglomerate, and branches of foreign firms[1].

(ii) **Resolution authority** – Each jurisdiction should have a designated administrative authority/authorities responsible for resolving the financial institutions by exercising the resolution powers/tools under the resolution regime. In case of multiple resolution authorities within a jurisdiction for resolving the financial institutions falling under their respective regulatory/supervisory jurisdiction, their roles and responsibilities and mandates should be clearly defined and coordinated. In case of different resolution authorities for resolving entities of the same group within a jurisdiction, a 'Lead Authority' should be identified for coordinating the resolution of the legal entities within

[1]This should not apply where jurisdictions are subject to a binding obligation to respect resolution of financial institutions under the authority of the home jurisdiction.

that jurisdiction. The resolution authority: (a) should have the expertise, resources and operational capacity to implement resolution measures; (b) should be operationally independent consistent with its statutory responsibilities; (c) should be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of resolution actions; (d) should be protected against liability for actions taken and omissions made in exercise of resolution powers in good faith; and (e) should have unimpeded access to firms for resolution planning.

(iii) **Resolution powers** – The resolution of any financial institution should be initiated when a financial institution is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so, and before it is balance-sheet insolvent and all equity has been fully wiped out. In order to take decisions for initiating resolution, clear standards or suitable indicators of non-viability need to be formulated.

The resolution authorities should have a broad range of resolution powers, including powers to (a) remove and replace senior management and directors, (b) appoint administrator to take control, (c) terminate, continue or assign contracts, purchase or sell assets, write down debt and any other action to restructure or wind-down the financial institution's operations, (d) ensure continuity of essential services and functions, (e) override rights of shareholders to effect various resolution options, (f) transfer or sell assets and liabilities including deposit liabilities to a solvent third party, (g) establish a bridge institution to take over and continue operating certain critical functions and viable operations of a failed financial institution, (h) establish a separate asset management vehicle and transfer non-performing loans for management and run-down, (i) carry out bail-in within resolution, (j) temporarily stay the exercise of early termination rights, (k) impose a moratorium, (l) effect orderly wind-down with timely pay-out, and (m) apply one or combination of resolution powers.

(iv) **Set-off, netting, collateralization, segregation of client assets** – The legal framework governing set-off rights, contractual netting and collateralization agreements and segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of financial institutions. Initiation of any resolution should not trigger statutory or contractual set-off rights, or entitle any counterparty to exercise contractual acceleration or early termination rights, provided the substantive obligations under the contract continue to be performed. Even in case of exercise of contractual acceleration or early termination rights, the resolution authority should have the power to stay temporarily such rights (strictly limited in time) arising due to resolution of financial institutions.

(v) **Safeguards – Respect of creditor hierarchy and "no creditor worse off" principle** – Resolution powers should respect the hierarchy of claims and also provide for flexibility to depart from the general principle of equal treatment of creditors of the same class. Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the financial institution under the applicable insolvency regime ("no creditor worse off than in liquidation" safeguard). The legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of measures by the resolution authorities. With a view to preserving market confidence, the resolution authority should have the power to allow temporary exemptions from disclosure requirements or postponement of disclosures required by the financial institution.

(vi) **Funding of firms in resolution** – Statutory or other policies should be in place so as to avoid relying on public ownership of bail-out funds as a means of resolving a failing firm. A privately-financed deposit insurance or resolution funds, or a funding mechanism should be put in place for *ex-post* recovery of the costs of providing temporary financing by the resolution authority to facilitate the resolution of the firm. Provisions should also be made, either from shareholders and unsecured creditors or from the wider financial system, for recovery of any losses incurred arising out of temporary funding by the resolution authority for orderly resolution. As a last resort, the resolution authorities could have power to place the firm under temporary public ownership and control (nationalization) in order to continue critical operations and seek to make arrangement for a permanent solution such as a sale or merger. Provision should strictly be made for recovery of losses from unsecured creditors or the financial system more widely.

(vii) **Legal framework conditions for cross-border cooperation** – The resolution authority should have the power to enter into a cooperative solution with foreign resolution authorities. The legal provisions/regulations should not provide for automatic action in a jurisdiction as a result of initiation of resolution proceedings in another jurisdiction, but the particular jurisdiction should have the discretionary power to take action, if necessary, to achieve domestic stability in the absence of effective international co-operation and information sharing. The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers either to support a resolution carried out by a foreign home authority or to take measures on its own initiative to maintain financial stability. The national laws/regulations should not discriminate against creditors on the basis of their nationality, location of their claims or the jurisdiction where it is payable, and should be transparent and properly disclosed to all creditors including depositors. The resolution

authority should have the legal power, subject to adequate confidentiality requirements and protection for sensitive data, to share information including recovery and resolution plans (RRPs) pertaining to the financial group as a whole or to individual subsidiaries or branches, with relevant foreign authorities for implementing a coordinated resolution. Jurisdictions should also provide for confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

(viii) **Crisis Management Groups (CMGs)** – With the objective of enhancing preparedness and facilitating the management and resolution of a cross-border financial crisis, both home and host authorities of all global systemically important financial institutions (G-SIFIs) should constitute and maintain CMGs. The membership of the CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes. The CMGs should cooperate closely with authorities in other jurisdictions where firms have systemic presence.

(ix) **Institution-specific cross-border cooperation agreements (COAGs)** – For all G-SIFIs, an institution-specific cooperation agreement should be in place and made public if agreed by the concerned authorities, between the home and relevant host authorities that need to be involved in the planning and crisis resolution stages.

(x) **Resolvability assessments** – The resolution authorities should regularly assess and evaluate the feasibility of resolution strategies *(continuity of critical financial services, extent of intra-group exposures and its impact on resolution, capacity of the firm to furnish detailed, accurate and timely information, and robustness of cross-border cooperation and information sharing arrangements)* at least for G-SIFIs and their credibility in the light of the likely impact of the financial institution's failure on the financial system. In order to improve a financial institution's resolvability, the supervisory authorities or resolution authorities should have powers, where necessary, to change a financial institution's business practices, structure or organization, reduce the complexity and cost of resolution, etc.

(xi) **Recovery and resolution planning** – Jurisdictions should put in place a robust and credible Recovery and Resolution Plans (RRPs), containing the essential elements, for all G-SIFIs and those other financial institutions that could have an impact on financial stability in the event of its failure. The firm's senior management should have the responsibility to provide the necessary input to the resolution authorities for assessment of the recovery plans, and the preparation of the resolution plans by the resolution authority.

(xii) **Access to information and information sharing** – There should not be any legal, regulatory or policy impediments hindering the appropriate exchange of information,

including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes. Sharing of all information relevant for recovery and resolution planning and for resolution should be possible in normal times and during a crisis at domestic as well as cross-border level. However, in case of sensitive information, information sharing may be restricted only among the top officials of the home and host authorities.

Indian Financial System

3.3 India's financial sector is diversified and expanding rapidly. It comprises banks, insurance companies, securities firms, non-banking financial institutions, provident and pension funds, mutual funds, and other financial entities.

3.4 Banks dominate the Indian financial system[1] with 63 per cent of the total assets of the financial system, followed by insurance companies having 19 per cent of financial assets. Non-banking Financial Institutions, Mutual Funds, and Provident and Pension institutions have 8 per cent, 6 per cent, and 4 per cent of the total financial assets, respectively. Within banking system, the scheduled commercial banks account for 92.4 per cent of total banking assets (of which, public sector banks have 67.2 per cent, private sector banks have 18.7 per cent and foreign banks have 6.5 per cent) followed by co-operative banks (rural and urban), regional rural banks, and local area banks with 3.4 per cent, 2.7 per cent and 1.5 per cent, respectively. The figures show that within the banking system, the public sector banks dominate with 72.8 per cent of market share of banking assets and 83 per cent of branches[2].

3.5 The Indian banking system includes commercial banks, regional rural banks (RRBs)[3], and co-operative banks *[State Co-operative Banks, District Central Co-operative Banks and Primary (Urban) Co-operative Banks[4]].* As on March 31, 2013, the Indian banking system comprised 93 scheduled commercial banks *[26 public sector banks, 24 private sector banks, and 43 foreign banks with branch presence]*, 64 RRBs, 31 state co-operative banks, 371 district central co-operative banks and 1,606 primary (urban) co-operative banks.

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[1]Data pertains to end-March 2012.
[2]Duvvuri Subbarao (August 2013) – Speech on "Banking structure in India – Looking ahead by looking back.
[3]The Regional Rural Banks (RRBs) were constituted in terms of Regional Rural Banks Act, 1976. They are small in size and have a limited area of operations extending from 1 to 15 districts. They do not give big ticket loans.
[4]Urban Co-operative Banks (UCBs) are generally small banks having operations confined to a state. However, there are a few multi-state co-operative banks. The balance sheet size of these banks is much smaller than banking companies and public sector banks.

In addition to the above deposit-taking institutions, there are other financial institutions, such as 12,225 Non-Banking Financial Companies (NBFCs)[1], 4 Development Financial Institutions, and 21 Primary Dealers (13 PDs are departmentally conducted by banks and 8 PDs are standalone) within the regulatory jurisdiction of the Reserve Bank of India.

3.6 The Indian insurance sector[2] comprises 24 life insurance companies, 28 general insurance companies and one reinsurer company. The securities market[3] comprises 198 merchant bankers, 50 mutual funds, 210 venture capital funds, 26 stock exchanges, 2 depositories, 867 depository participants (of which 285 are connected with NSDL and 582 with CDSL), 62 Qualified Depository Participants, 9,532 stock brokers in cash segment, 4,964 corporate stock brokers, 3,066 stock brokers in equity derivative segment, 2,372 stock brokers in currency derivative segment, 55,542 sub-brokers, 32 debenture trustees, 6 credit rating agencies, etc. In addition, there are other financial institutions, such as Housing Finance Companies (HFCs), and provident & pension funds, which form a part of Indian financial system. The Indian financial system is supplemented by the financial market infrastructures (FMIs)[4] (payment systems, clearing houses, central counterparties, securities settlement systems, securities depositories, etc.).

Regulatory Framework for Indian Financial System

3.7 The regulation and supervision of the financial system in India is carried out by different regulatory authorities – the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority (IRDA), Securities and Exchange Board of India (SEBI), Pension Fund Regulatory and Development Authority (PFRDA), and Forward Markets Commission (FMC).

Reserve Bank of India

3.8 Reserve Bank of India (RBI) is the country's central banking authority and apart from the usual central banking functions like monetary policy formulation, is involved in the

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[1]NBFCs are companies registered under the Company Law, engaged in the business of loans and advances, acquisition of shares, stock, bonds, hire-purchase, insurance business, or chit business: but does not include any institution whose principal business is agriculture or industrial activity; or the sale, purchase or construction of immovable property.

[2]Information furnished by IRDA.

[3]Information furnished by SEBI and data pertain as on November 30, 2013.

[4] Financial Market Infrastructure (FMI) is defined as a multilateral system among participating financial institutions, including the operator of the system, used for the purpose of recording, clearing or settling payments, securities, derivatives or other financial transactions. It includes the systemically important payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs), and trade repositories (TRs).

regulation and supervision of commercial banks, regional rural banks, co-operative banks[1], non-banking financial companies, development finance institutions and certain FMIs *[Real Time Gross Settlement (RTGS) System, Securities Settlement System (SSS), Clearing Corporation of India Limited (CCIL) and the Negotiated Dealing System Order-matching (NDS-OM)]*[2].

3.9 There is a dual control with respect to cooperative banks. Incorporation, management and winding up of primary co-operative banks[3] is regulated either by the authorities under State Cooperative Societies Acts of each state (if the societies are operating in a single state) or the Central Act, namely, Multi-state Cooperative Societies Act, 2002 (if the societies are operating in more than one state). Regulation of incorporation, management and winding up of state co-operative banks and district central cooperative banks[4] is with the authorities under the State Cooperative Societies Acts of each state. The banking functions of primary co-operative banks is regulated and supervised by RBI and that of rural cooperative banks, by the National Bank for Agriculture and Rural Development (NABARD).

Securities and Exchange Board of India

3.10 Securities and Exchange Board of India (SEBI)[5] regulates the Indian securities market, including merchant bankers, mutual funds, venture capital funds, stock brokers, sub-brokers, debenture trustees, KYC Registration agencies, registrars and underwriters to stock issues, foreign institutional investors and credit rating agencies. In addition, it also regulates certain FMIs – stock exchanges (in cash market and derivatives market), depositories and clearing corporations.

Insurance Regulatory and Development Authority (IRDA)

3.11 Insurance Regulatory and Development Authority (IRDA)[6] is the statutory body for the regulation and development of insurance industry in India. The IRDA regulates life insurance companies, general insurance companies and reinsurance companies. In

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[1]Supervision of state co-operative banks, district central co-operative banks and regional rural banks is carried out by the National Bank for Agriculture and Rural Development (NABARD).
[2]While RTGS and SSS are owned and operated by RBI, NDS-OM is owned by RBI and operated by CCIL. The CCIL acts as central counterparty for segments and also acts as trade repository in certain segments.
[3] Commonly referred to as Urban Cooperative Banks (UCBs).
[4]Commonly referred to as Rural Cooperative Banks.
[5]SEBI was constituted as an administrative organ in the Department of Economic Affairs vide a Resolution of the Government of India in April 1988, and later established in 1992 as the first statutory autonomous regulator in the Indian Securities Markets.
[6]IRDA was constituted in terms of Insurance Regulatory and Development Authority Act, 1999.

addition, IRDA also regulates intermediaries such as agents, corporate agents, brokers, third party administrators, surveyors and loss assessors and web aggregators.

Pension Fund Regulatory and Development Authority

3.12 Pension Fund Regulatory and Development Authority (PFRDA)[1] is mandated to regulate the 'National Pension System' (NPS) for government employees as well as other citizens of India, through its registered intermediaries, such as Central Recordkeeping Agency (CRA), Pension Fund Managers (PFMs) for professional management and investment of subscriber funds, Points of Presence (POP's) for distribution of the product, Trustee Bank, Custodians, NPS Trust, and aggregators as per the agreement with these entities.

Forward Markets Commission

3.13 The Forward Markets Commission (FMC)[2] regulates the commodity derivative markets. It includes six national exchanges facilitating forward trading in 113 commodities, and 11 commodity specific regional exchanges recognized for trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952.

Other regulators

3.14 The housing finance companies are regulated by National Housing Bank (NHB). The Department of Company Affairs (DCA), Government of India regulates deposit taking activities of companies (other than NBFCs) registered under Companies Law.

Regulation of Financial Conglomerates

3.15 In India, financial groups are identified as Financial Conglomerates (FCs) on the basis of their significant presence in two or more market segments (Banking, Insurance, Securities, Non-Banking Finance and Pension). RBI has limited powers[3] to call for information and to inspect jointly with other financial sector supervisors, the associate enterprises of banks. As an important step towards a more effective consolidated supervision of the FCs, the four financial sector regulators in India, viz. RBI, SEBI, IRDA and PFRDA, have signed a Memorandum of Understanding (MoU) for cooperation in the field of consolidated supervision and monitoring of FCs. The Inter Regulatory Forum (IRF) is

[1] The PFRDA was originally established by the Government of India through a resolution dated 10th October, 2003 & 14th November, 2008, has since attained a statutory status post the passage of Pension Fund Regulatory and Development Authority Act, 2013.

[2] FMC was constituted as a statutory body in 1953 in terms of the Forward Contract (Regulation) Act, 1952.

[3] Section 29A of Banking Regulation Act, 1949 inserted by Act 4 of 2013 (w.e.f. 18-1-2013).

structured as a college of domestic supervisors by adopting the lead/principal regulator model, with a mandate to carry out two major functions, viz. developing supervisory cooperation for effective consolidated supervision of FCs and assessing the risk to systemic financial stability due to activities of the FCs.

Financial Stability

3.16 RBI's main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. The objective also encompasses to protect the public interest, or the interest of the banking policy, or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company.

3.17 IRDA's objective is to protect the interests of the policyholders and to ensure the orderly growth of the insurance sector. The objective of SEBI is to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto. On the other hand, PFRDA promotes old age income security by establishing, developing and regulating pension funds, and also protects the interest of the subscribers to the schemes of pension funds and for matters connected therewith or incidental thereto.

3.18 The existing legal framework does not explicitly provide statutory powers to any authority to maintain financial stability. With a view to establishing a body to institutionalize and strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination, the Government of India has, in consultation with the financial sector regulators, set up, in December 2010, the Financial Stability and Development Council (FSDC) headed by the Finance Minister, Government of India. The Council also deals with issues relating to financial literacy, financial inclusion, macro prudential supervision of the economy including the functioning of large financial conglomerates, and coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB) and any such body as may be decided by the Ministry of Finance from time to time. A sub-Committee of FSDC, headed by the Governor of RBI, has been constituted with the mandate to maintain financial stability and inter-regulatory coordination. The sub-Committee of the FSDC has also set up various Working Groups/Technical Groups to deal with wide-ranging issues connected with financial stability. These include – (i) Inter-regulatory Technical Group, (ii)

Technical Group on Financial Inclusion and Financial Literacy, (iii) Inter-regulatory forum for monitoring financial conglomerates, (iv) Early Warning Group, and (v) Working Group on Resolution Regime for Financial Institutions.

Legal Framework for Resolution of Financial Institutions

3.19 As of now, India does not have a special resolution regime or comprehensive policy or law on bankruptcy exclusively for the financial institutions as a whole. However, there are some provisions contained in various Acts which empower the respective regulator/supervisor and/or the central government to resolve different types of problem financial institutions in India. These provisions are contained in –

- Banking Regulation Act, 1949 and Companies Law for banking companies (private sector banks, foreign banks and Local Area Banks);
- State Bank of India Act, 1955, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, SBI (Subsidiary Banks) Act, 1959 and Banking Regulation (BR) Act, 1949 for public sector banks including State Bank of India and its subsidiaries;
- Banking Regulation Act (As Applicable to Co-operative Societies), 1966, the Multi-State Co-operative Societies Act, 2002 and respective State Co-operative Societies Acts for co-operative banks (State Co-operative Banks, District Central Co-operative Banks and Primary Co-operative Banks);
- Regional Rural Banks Act, 1976 and Banking Regulation Act, 1949 for Regional Rural Banks;
- Insurance Act, 1938 , Insurance Rules, 1939, IRDA Act, 1999 and the regulations framed thereunder for insurance companies;
- The Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 and Stock Exchanges and Clearing Corporations Regulations, 2012 for Securities companies/brokers and stock exchanges;
- The Reserve Bank of India Act, 1934 and Companies Law for Non-Banking Financial Companies; and
- Pension Fund Regulatory and Development Authority, 2013 for pension companies.

Existing Resolution Regime and Assessed Gaps

3.20 The present status and the assessed gaps in the Indian resolution regime, *vis-à-vis* the Key Attributes, in respect of all financial institutions, including banks, NBFCs, insurance companies, securities companies/brokers, pension funds and FMIs are given as under.

Scope of resolution regime

3.21 India does not have a special resolution regime or comprehensive policy or law on bankruptcy exclusively for the financial institutions as a whole. However, there are some provisions contained in various Acts which empower the respective regulator/supervisor and/or the central government to resolve different types of problem financial institutions in India. Though the resolution powers are limited as compared to FSB Key Attributes, the existing legal provisions contained in various Acts that govern the functioning of financial institutions are applicable for resolving the private sector banks, branches of foreign banks, public sector banks, co-operative banks, insurance companies, securities companies, non-banking financial companies, and FMIs.

3.22 The powers, however, vary from institution to institution. While the powers are inadequate and required to be enhanced in respect of banks and insurance companies to meet global best practices, they are absolutely minimal in respect of FMIs. The existing resolution regime in respect of co-operative banks is in the form of a supervisory action framework which envisages self-corrective action in the initial stages of weakness and involves stringent supervisory action in the event of financials not improving. Though there is no special resolution regime for FMIs, the provisions of Company Law apply. Similarly, the provisions of Company Law apply to the NBFC sector.

3.23 However, the resolution powers are applicable only to the specific categories of licensed financial institutions on a solo basis and not to the institution's holding company or subsidiaries. As such, the existing legal framework does not permit the authorities to extend resolution proceedings to regulated or unregulated subsidiaries of a regulated entity or subsidiaries of a regulated or un-regulated entity's holding company.

Resolution Authority

3.24 There is no dedicated resolution authority responsible for overseeing and implementing resolutions of financial institutions as a whole. However, the respective regulators/supervisors and/or the central government have been exercising their powers under the statutes mentioned above, where considered necessary, for resolving the problem financial institutions falling under their respective regulatory jurisdictions and have been able to achieve their regulatory objectives, without involving taxpayers' money. Even for resolution of financial groups, there is no lead authority as of now though the FSDC has been institutionalized by the Government of India to strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination.

FSDC and its sub-committee are not statutory bodies and thus lack sufficient legal powers and backing to resolve a financial group in real time.

Resolution Powers and Tools

Banking Companies, Foreign Bank Branches and Public Sector Banks

3.25 The legal provisions relating to the procedure and powers for amalgamation, merger or liquidation of entities is spread out in different enactments depending on the constitution of the entity. The foreign banks having presence in the form of branches are governed by the provisions of Banking Regulation Act, 1949 and to certain extent, the Indian Company Law. The provisions that provide powers to the RBI and/or the central government for resolution of commercial banks are detailed below.

Power to appoint and remove directors

3.26 RBI is empowered to remove[1] any person who has been elected to be chairman of the Board of Directors or the Managing Director of a banking company, if it is of the opinion that such person is not a fit and proper person to hold such office. In addition, RBI has the power to remove[2] any chairman, director, chief executive officer or other officer or employee of the banking company (private sector banks, foreign banks and LABs) and appoint suitable person in that place. Additional directors[3] can also be appointed by RBI under certain circumstances.

3.27 The Chairman and managing directors of SBI[4] and whole-time directors[5] of nationalised banks are appointed by Central Government in consultation with RBI. The central government has the power to remove the Chairman or Managing Director of SBI[6] and its subsidiaries[7] after consultation with the Reserve Bank. RBI is empowered[8] to remove directors of nationalised banks under certain circumstances and appoint additional directors[9]. The State Bank of India may, in consultation with the RBI and with the approval of central government, remove[10] certain directors of its subsidiary banks.

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[1]Section 10B (6) of BR Act, 1949.
[2]Section 36AA of BR Act, 1949.
[3] Section 36AB of BR Act, 1949.
[4]Clauses (a) and (b) of Section 19 of SBI Act, 1955.
[5] Section 9(3)(a) of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980.
[6]Section 24 of SBI Act, 1955.
[7]Section 29 of State Bank of India (Subsidiary banks) Act, 1959.
[8]Section 9(3B)of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980.
[9] Section 9A of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80.
[10]Section 31 of SBI (subsidiary banks) Act, 1959.

Power to issue directions and prohibition from entering a particular business

3.28 RBI is vested with the power to give[1] directions to banks (banking companies and public sector banks) in public interest as also to prevent the affairs of a bank from being conducted in a manner detrimental to the interests of its depositors or prejudicial to its own interests. RBI may caution[2] or prohibit banks from entering into any particular transaction.

Power to terminate contracts, write down debts, etc.

3.29 The power to terminate contracts or write down debts, etc., of banks has not been explicitly provided in the statutes. However, the powers under section 35A of BR Act, 1949 and the scope of the scheme that may be made by RBI under section 45 of that Act when a banking company is placed under moratorium are in very wide terms. It may therefore be possible in extreme cases to provide for termination of contracts, etc., to resolve a banking company.

Power to override rights of shareholders

3.30 Shareholders of banks cannot come in the way of the exercise of any of the powers conferred on RBI or Central Government under any of the statutes in question. However, they have the right to challenge the decisions of RBI and central government in courts if they are aggrieved in any manner.

Power to acquire and/or transfer or sell assets and liabilities, legal rights and obligations

3.31 The central government, in consultation with the RBI, is empowered[3] to acquire undertakings of banking companies, if it is satisfied that such banking company has failed to comply with RBI directions relating to banking policy issued under Section 21 or Section 35A of BR Act, 1949; or is being managed in a manner detrimental to the interests of its depositors. If the central government is satisfied that the undertaking of the acquired bank and its assets and liabilities should, instead of vesting in itself, be vested[4] in a company established under any scheme or in any corporation (referred to as the transferee bank), it may order the transfer of assets and liabilities of such undertaking to the transferee bank.

3.32 Further, the Central Government can make a scheme[5], after consultation with the Reserve Bank of India, for constitution of the transferee bank in relation to transfer of the

[1] Section 35A of BR Act, 1949.
[2] Section 36(1)(a) of BR Act, 1949.
[3] Section 36AE of BR Act, 1949.
[4] Section 36 AE (4) of BR Act, 1949.
[5] Section 36AF of BR Act, 1949.

acquired undertaking including the property, assets and liabilities of the acquired bank, its capital, name and office, constitution of first Board of management, continuance of services of employees of the acquired bank, continuance of right of any person who is entitled to or is in receipt of, manner of payment of compensation to the shareholders of the acquired bank, etc.

Power to supersede the Board and appoint administrators

3.33 The RBI is empowered to supersede[1], after consultation with the central government, the Board of Directors of banking companies and to appoint[2] an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks[3], SBI[4] and subsidiary banks[5] of SBI under certain circumstances and appoint Administrator.

Power to apply for moratorium and prepare scheme of amalgamation

3.34 RBI is empowered to apply to the central government for suspension[6] of the business of a banking company and to prepare a scheme for its reconstruction or amalgamation with any other banking institution. The scheme may, inter-alia, contain provisions for the capital, assets, powers, rights, interests, authorities and privileges, liabilities, duties and obligations of banking company on its reconstruction or of the transferee bank; terms & conditions of transfer of business, properties, assets and liabilities of a banking company to the transferee bank; any change or appointment in/of the board of directors; alteration of memorandum articles of association of banking company on its reconstruction or of the transferee bank; reduction of interests or rights of depositors and other creditors; allotment of shares to the members of the banking company on its reconstruction or in the transferee bank on amalgamation, etc.

3.35 As regards nationalised banks, the central government may, after consultation with the RBI, make a scheme[7], inter-alia, for the reconstruction of any nationalised bank into two or more corporations or amalgamation of such banks.

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[1]Section 36ACA of BR Act, 1949.
[2]Section 36ACA (2) of BR Act, 1949.
[3]Section 18A of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.
[4]Section 24A of SBI Act, 1955.
[5]Section 35A of SBI (Subsidiary Banks) Act, 1959.
[6]Section 45 of BR Act, 1949.
[7]Section 9 (2) (c) of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.

Liquidation and appointment of liquidators

3.36 The RBI can make an application to the High Court[1] for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.

3.37 The Reserve Bank can also make an application to the High Court for winding up[2] of a banking company, if the banking company has failed to comply with the statutory requirements (i.e. non-compliance of requirement of minimum paid-up capital and reserves; non-compliance of other statutory provisions), or has been prohibited from accepting fresh deposits, or if in the opinion of the RBI, the continuance of the banking company is prejudicial to the interests of its depositors or is unable to pay its debts, or a compromise or arrangement sanctioned by a court cannot be worked satisfactorily. RBI, SBI and any other bank notified by the central government shall be appointed as the Official Liquidator[3] in case of a banking company that is under any proceedings for the winding up by the High Court.

3.38 The SBI[4], subsidiary banks[5] of SBI, nationalised banks[6] and RRBs[7] cannot be liquidated under company law but can be placed under liquidation by an order of the central government.

3.39 An analysis of various provisions of BR Act, 1949 shows that the RBI/central government do have the capacity to use certain resolution tools like private sector purchase tool (compulsory amalgamation), temporary public ownership tool and bridge bank tool in respect of private sector banks and branches of foreign banks. However, the existing legislation does not provide for other resolution tools like bad-bank and good-bank, bail-in within resolution, etc. for the resolution authority to exercise upon. As regards public sector banks, the existing legal framework does not provide any specific powers to the RBI or the central government to exercise any resolution tool, except for liquidation.

3.40 The extant legal framework, however, does not specify or provide powers to the RBI or the central government to ensure continuity of essential services and functions of the failing banks. Exercise of any of the above mentioned powers do not require any express approval from the shareholders of the concerned bank in resolution.

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[1] Section 37 of BR Act, 1949.
[2] Section 38 of BR Act, 1949.
[3] Section 39 of BR Act, 1949.
[4] Section 45 of SBI Act, 1955.
[5] Section 57 of SBI (Subsidiary banks) Act, 1959.
[6] Section 18 of Banking Companies (Acquisition and transfer of undertakings) Act, 1970/80.
[7] Section 26 of RRB Act, 1976.

Urban Co-operative Banks

3.41 RBI has the power to supersede[1] the Board of Multi-State urban co-operative banks (UCBs). For UCBs under the State Co-operative Societies Acts, the RBI can request the Registrar of Co-operative Societies (RCS) to supersede the Board and in view of the provisions of the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961 such a requisition of the Reserve Bank has to be honoured by the RCS. However, in case of UCBs governed by the State Co-operative Societies Acts, the RBI can request the Registrar of Co-operative Societies (RCS) to supersede[2] their board and the same is binding on the RCS. RBI also has the powers to apply to Central Government for suspension of business and issue of Order of Moratorium. Accordingly, the Central Registrar of Co-operative Societies has the powers to prepare a scheme of amalgamation for such co-operative banks.

3.42 Guidelines on merger of UCBs and transfer of assets and liabilities to commercial banks are in place but all such resolution strategies are voluntary and need consent of General Body of the bank. The RBI has the powers to restrict the activities and give directions[3] to a UCB and to a limited extent these can be considered as resolution measures not amounting to liquidation. On cancellation of the banking license by RBI, the liquidator is appointed by the State Government who carries out liquidation under the provisions of the State Co-operative Societies Act. The payment by DICGC in such situations is similar to that followed for commercial banks.

3.43 The RBI does not have any other power or tools in order to effectively resolve these banks. However, within the existing legal framework, Memorandum of Understandings (MoUs) have been entered into by RBI with all the State Governments. A Task Force on Urban Co-operative Banks (TAFCUB) has been constituted in all States comprising of representatives from RBI, Government and the Federation with a mandate to find revival path for the viable urban co-operative banks and non-disruptive exit for the non-viable entities. These TAFCUBs have no legal backing.

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[1] Section 36AAA of BR Act, 1949 (AACS).

[2] Second proviso of Article 243ZL(1) of the Constitution of India introduced by the 97th amendment to the Constitution states that the provisions of BR Act also apply to supersession of boards of cooperative banks. However, a Division Bench of Gujarat High Court has held in Rajendra Shah v. India being WP (PIL) 166 of 2012 by order dated April 22, 2013 that the said 97th amendment is unconstitutional. The matter is pending in Supreme Court.

[3] Section 35A and 36 of BR Act, 1949 (AACS).

Regional Rural Banks

3.44 In terms of RRBs Act, 1976, no provision of law relating to the winding up[1] of companies shall apply to a RRB except by order of the Central Government and in such manner as it may direct. The sponsor bank of RRBs may, at any time remove the Chairman from office subject to some conditions.

3.45 Thus, the existing legal framework does not provide any specific powers to the RBI or the central government to exercise any resolution tool, except for liquidation, in respect of these banks.

Non-Banking Financial Companies

3.46 Merger, amalgamation, acquisition, etc. of NBFCs are governed by Company law and there is no specific power with RBI to deal with such matters. The RBI Act, 1934, governing the activities of NBFCs, provides certain powers to the Reserve Bank of India for dealing with problem NBFCs. However, these are restricted to prohibition of deposit taking activities, alienation of assets and cancellation of Certificate of Registration for carrying out business. Under Section 45MC of RBI Act, the Reserve Bank may file a winding up petition to the judiciary. All provisions of company law are applicable to such winding up[2].

3.47 The Company Law provides that if the Central Government or the Reserve Bank of India, inter-alia, have sufficient reasons to believe that any company has become, for the purposes of the Act, ibid, a sick company[3], they can make a reference in respect of such company to the Tribunal for determination of the measures which may be adopted with respect to such company. The Tribunal may, in turn, after considering facts in the matter, order for winding of the company. RBI Act also empowers RBI to call for information[4] from financial institutions and to give directions to those and to prohibit acceptance of deposit[5] and alienation of assets. The efficacy of these provisions for effecting resolution is doubtful.

3.48 The above mentioned powers conferred upon the central government or the RBI do not relate in any way to the resolution powers as prescribed by the Key Attributes.

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[1] Section 26 RRB Act, 1976.
[2] Section 45MC(4) of RBI Act, 1934.
[3] Section 253(5) of Companies Act, 2013
[4] Section 45L of RBI Act, 1934.
[5] Section 45MB of RBI Act, 1934.

Insurance Sector

Power to issue directions

3.49 The IRDA is empowered to issue directions[1] to insurers generally or to any insurer in particular, if it is satisfied that it is necessary in the public interest; or to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policy-holders or in a manner prejudicial to the interests of the insurer; or generally to secure the proper management of any insurer.

Power to appoint and remove directors

3.50 IRDA has the power to remove[2] any director or the chief executive officer of the insurer, from office and appoint any suitable person in place of the director or chief executive officer who has been removed from his office. It is also empowered to appoint[3] one or more persons to hold office as additional directors of the insurer, provided the number of additional directors shall not exceed five or one-third of the maximum strength fixed for the Board.

Power to appoint Administrator

3.51 The Central Government, based on the report of the IRDA, is empowered to appoint an Administrator[4] to control the affairs and conduct the management of the business of the insurer.

Power to acquire and/or transfer undertakings of insurers

3.52 The central government has the power to acquire[5] the undertaking of an insurer, provided the government is satisfied that an insurer has persistently failed to comply with directions given under Section 34, 34-F or Section 34-G or any order made under Section 34-E, or is being managed detrimental to the public interest or to the interests of his policy-holders or shareholders.

Power of investigation and inspection by IRDA

3.53 On receipt of report of investigation conducted under Section 33 of the Insurance Act, IRDA may, inter-alia, cancel the registration of insurer or direct any person to apply to court for the winding of the insurer.

[1] Section 34 of Insurance Act, 1938
[2] Section 34B of Insurance Act, 1938.
[3] Section 34C of Insurance Act, 1938.
[4] Section 52A of Insurance Act, 1938.
[5] Section 52H of Insurance Act, 1938.

Power to make scheme of amalgamation

3.54 The IRDA may prepare a scheme[1] for the amalgamation of an insurer with any other insurer, provided it is satisfied that it is necessary to do so in the public interest, or in the interests of the policy-holders, or in order to secure the proper management of an insurer, or in the interest of insurance business of the country as a whole. Such scheme shall be sanctioned by the Central Government with or without any modification.

Jurisdiction over foreign branches of Indian insurance firms

3.55 The IRDA is empowered to direct any branch outside India of an insurer incorporated in India, to stop carrying on insurance business[2] in the country in which such branch is situated within a specified period, not being less than one year, if it has reasons to believe that the working of any branch outside India of an insurer is generally resulting in a loss or that the affairs of that branch are being conducted in a manner prejudicial to the interests of the policyholders or the public interest..

Winding-up

3.56 The central government is empowered[3] to constitute a Tribunal, which shall have the powers of a civil court, for the purpose of Section 52H to 52J (that provide for acquisition of the undertaking of insurers in certain cases). The Tribunal may order the winding[4] up of an insurer in accordance with the provisions of the Companies Act which shall be subject to the provisions of the insurance Act, 1938 and shall apply accordingly.

3.57 The IRDA can also apply to the Tribunal for the winding up of an insurance company in specified circumstances[5], namely failing to hold deposits under Section 7; continued failure to comply with the requirements of the Insurance Act for a period of three months after issue of notice of such failure; company appears to be insolvent on the basis of returns filed/investigation reports; or where continuation of the company is considered to be prejudicial to the interests of policyholders or public.

Power of Tribunal to reduce contracts of insurance[6]

3.58 In case of winding up of an insurance company or in case of insolvency of any other insurer, the Tribunal may make an order for reducing the amount of the insurance contracts

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[1]Section 52H of insurance Act, 1938.
[2]Section 34G of Insurance Act, 1938.
[3] Section 52K of Insurance Act, 1938.
[4]Section 53 of Insurance Act, 1938.
[5] Section 53(2)(b) of Insurance Act, 1938.
[6] Section 55(2) of Insurance Act, 1938.

of the company. For this purpose, the assets and liabilities of the company and all claims in respect of policies issued by it shall be ascertained in such manner and on such basis as the Tribunal considers appropriate.

Segregation of client assets

3.59 All insurance companies – both life and non-life – are required[1] to keep a separate account of all receipts and payments in case of each class of insurance business carried on by them. In case of winding up/insolvency of an insurer, the value of assets and liabilities of the life insurance business shall be ascertained separately from the value of any other assets or any other liabilities of the insurer. The Insurance Act provides that no assets shall be applied to the discharge of any liabilities other than those in respect of life insurance business[2], except in so far as those assets exceed the liabilities in respect of life-insurance business. Thus, the assets, liabilities and the income derived from the assets of the 'policyholders' are clearly identifiable.

3.60 Various provisions of Insurance Act, 1938 empower the IRDA and/or the central government to use certain resolution powers and tools like private sector purchase tool (compulsory amalgamation), and temporary public ownership tool in respect of insurance companies. However, the existing legislation does not provide for other resolution tools like bail-in[3] within resolution, etc. for the resolution authority to exercise upon.

Financial Market Infrastructures (FMIs)

3.61 Financial Market Infrastructures (FMIs) are defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. FMIs comprise Central Counter Parties (CCPs), trade repositories, critical payment systems, securities settlement systems and central securities depositories. FMIs facilitate the clearing and settlement of monetary and other financial transactions, such as payments, securities and derivative contracts (including derivatives contracts for commodities).

FMIs under regulatory jurisdiction of RBI

3.62 The FMIs that are within the regulatory jurisdiction of the RBI are the Real Time Gross Settlement (RTGS) System, Securities Settlement System (SSS), Clearing

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[1] Section 52K of Insurance Act, 1938.
[2] Section 56 of Insurance Act, 1938.
[3] The regulatory provisions presently do not permit insurance companies to leverage their balance sheet.

Corporation of India Limited (CCIL) and the Negotiated Dealing System Order-matching (NDS-OM). While the RTGS and the SSS are owned and operated by the RBI, the NDS-OM is owned by RBI but operated by the CCIL. CCIL is the central counterparty, authorised by RBI under the Payment and Settlement Systems (PSS) Act, 2007, for transactions in government securities, CBLOs, market repo, foreign exchange spot trade and foreign exchange forward trade. CCIL is also a Trade Repository in the segments approved by the RBI.

3.63 The PSS Act, 2007 designates the RBI as the authority for regulation and supervision of payment systems. However, the existing provisions of the PSS Act do not lay down any special resolution framework for payment systems. There is no provision in the RBI Act or the PSS Act at the moment either for recapitalization of or orderly wind down or reorganization of FMIs regulated by the Reserve Bank. In the absence of a specific legal mandate, the insolvency proceedings as laid down under the Company Law would be applicable.

FMIs under regulatory jurisdiction of SEBI

3.64 SEBI regulates various types of FMIs, such as (i) stock exchanges – Bombay Stock Exchange, National Stock Exchange, MCX SX, United Stock Exchange and other regional stock exchanges, (ii) Clearing Corporations - Indian Clearing Corporation Ltd. (ICCL), MCX-SX Clearing Corporation Ltd. (MCX-SXCCL), National Securities Clearing Corporation Ltd. (NSCCL), and (iii) the depositories – Central Depository Services Ltd. (CDSL), National Securities Depository Ltd. (NSDL), etc.

3.65 Various provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 and Stock Exchanges and Clearing Corporations Regulations, 2012, Depositories Act, 1996 as well as Depository and Participants Regulations, 1996 give powers to SEBI to pass directions, appoint board members, remove board members and take such action as provided in Acts/Regulations against stock exchanges, depositories and clearing corporations.

3.66 In terms of Section 12A of the Securities Contracts (Regulation) Act, 1956, SEBI is empowered to issue directions to any stock exchange or clearing corporation or agency or person providing trading or clearing or settlement facility in respect of securities, or to any person or class of persons associated with the securities market, or to any company whose securities are listed or proposed to be listed in a recognized stock exchange, if SEBI is

satisfied that it is necessary in the interests of investors or orderly development of securities market, or to prevent the affairs of any recognized stock exchange or clearing corporation or such other agency or person being conducted in a manner detrimental to the interests of the investors or securities market, or to secure the proper management of any stock exchange or clearing corporation or agency or person.

3.67 SEBI has taken following regulatory measures in respect of FMIs regulated by it:

(i) All stock exchanges have a separate legal entity as a clearing corporation, which ensures that any risk to the capital of a clearing corporation will not spill over to the stock exchange. These clearing corporations/houses have comprehensive risk management models to protect themselves against the default of any of its members. The risk management model followed by these clearing corporations is briefed in **Box 3.1**.

(ii) With a view to ensuring their financial capabilities and risk absorbing capacity, the minimum net worth requirement of stock exchanges and Clearing Corporations has been enhanced. The net worth of Clearing Corporation has been stipulated as ₹ 300 crore. As on March 31, 2013, networth of the three clearing corporations viz., ICCL, NSCCL and MCX-SX CCL was ₹ 420.99 crore, ₹ 949.8 core and ₹ 28.06 crore respectively. In case of insufficiency of funds during a default, the net worth of Clearing Corporation may be utilised.

(iii) With a view to providing timely exit to non-operational stock exchanges or stock exchanges where the annual trading turnover on its own platform is less than ₹ 1000 crore, guidelines have been spelt out for de-recognition and exit, avoiding any possible scenario of their resolution.

(iv) The SEBI (Depositories and Participants Regulations), 1996 provide for insurance against risks. Every depository is required to take adequate measures including insurance to protect the interests of the beneficial owners against risks likely to be incurred on account of its activities as a depository.

(v) As per the Depositories Act, 1996, the depositories are required to indemnify the loss caused to the beneficial owner due to the negligence of the depository or the participant.

BOX 3.1

Risk Management Model of Clearing Corporations

The Clearing Corporations acting as CCPs impose different types of margins like initial margin, extreme loss margin, mark to market (MTM) margin and other types of margins to cover their exposures. In the

derivatives segment, there are position limits prescribed by SEBI to mitigate the risk arising out of concentration of positions. The initial margin on positions of a clearing member (CM) is computed on a real time basis i.e. for each trade. The initial margin amount is reduced from the effective deposits of the CM with the Clearing Corporation. For this purpose, effective deposits are computed by reducing the total deposits of the CM by ₹ 50 lakh (referred to as minimum liquid net worth). The CM receives warning messages on his terminal when 70%, 80%, and 90% of the effective deposits are utilised. On reaching 100%, the clearing facility provided to the CM is withdrawn. Withdrawal of clearing facility of a CM in case of a violation will lead to withdrawal of trading facility for all Trading Members (TM) and/or custodial participants clearing and settling through the CM.

Similarly, the initial margins on positions taken by a TM are computed on a real time basis and compared with the TM limits set by his CM. The initial margin amount is reduced from the TM limit set by the CM. Once the TM limit has been utilised to the extent of 70%, 80%, and 90%, a warning message is received by the TM on his terminal. At 100% utilization, the trading facility provided to the TM is withdrawn.

Also, SEBI has provided system of **Risk Reduction Mode** wherein the stock exchanges shall ensure that the stock brokers are mandatorily put in risk-reduction mode when 90% of the stock broker's collateral available for adjustment against margins gets utilized on account of trades that fall under a margin system. Such risk reduction mode shall include the following:

a. All unexecuted orders shall be cancelled once stock broker breaches 90% collateral utilization level.
b. Only orders with Immediate or Cancel attribute shall be permitted in this mode.
c. All new orders shall be checked for sufficiency of margins.
d. Non-margined orders shall not be accepted from the stock broker in risk reduction mode.
e. The stock broker shall be moved back to the normal risk management mode as and when the collateral of the stock broker is lower than 90% utilization level

The margin models are back tested on a quarterly basis in order to assess the adequacy vis-à-vis exposures of CCPs. In addition to the above, CCPs also maintain a **'Settlement Guarantee Fund' (SGF)**. The objective of SGF is to ensure that there is no delay in settlement due to failure of any member to honour his commitment on time. While there is no fixed formula for estimating the corpus of the fund, SEBI has prescribed certain factors for assessing the fair quantum of SGF, which inter-alia includes track record of default of member in last 10 years; settlement liability of top 10 brokers in the highest settlement in last one year. For determining the minimum level of corpus, certain norms have been prescribed which inter-alia includes a simultaneous default by top 10 brokers for highest settlement in last one year settlement liability-wise. CCPs regularly conduct stress tests to determine the adequacy of the SGF.

Size of SGF

As of October 31, 2013, the total size of SGF of Clearing Corporations of three stock exchanges is ₹ 44,381 crore – (i) Clearing Corporation of BSE (ICCL) has ₹ 3,439 crore; (ii) Clearing Corporation of NSE (NSCCL) has ₹ 39,321 crore; and (iii)Clearing Corporation of MCX-SX (MCX-SX CCL) has ₹ 1,620 crore.

Composition of SGF

The Fund consists of:

(a) contributions from the Exchange;
(b) interest, dividend or other income arising from investments of the Fund and from any utilisation from the Fund,
(c) accretions arising from investments of the Fund,
(d) any money or property which the Relevant Authority is entitled to appropriate to the Fund, and
(e) any other funds, contribution (non-refundable) or penalties collected from Clearing Members, money or property which the Relevant Authority may decide to be the part of the fund from time to time,

Utilisation of Fund

In the event of a clearing member being declared a defaulter and the clearing member fails to meet the clearing and settlement obligations to the clearing corporation arising out of clearing and settlement operations of such deals as provided in the Rules, Bye Laws and Regulations, the relevant authority may utilise the Fund and other monies to the extent necessary to meet the obligations.

There are a few instances during the last 10 years when the brokers faced financial difficulties. However, the collaterals maintained by them with the stock exchanges adequately covered the position of members. The number of such instances is three each on BSE and NSE. On NSE, there were two more instances of default by the brokers, however, this was because of the reason of their not paying to clients and there was no default at the time of settlement in stock exchange

According to information provided by BSE, in last 10 years, there has been no case of utilization of SGF on account of settlement default. However, NSE utilized members' deposits (given below) to recover settlement shortages on 3 instances totalling to about ₹ 16.23 crore, without using any funds from SGF.

Year	Segment	Member deposit utilized towards settlement shortage (in ₹ crore)	No. of members declared defaulter	Whether SGF was utilized
2004	CM	0.085	1	No
2007	CM	0.024	1	No
2013	F&O	16.12 (approx.)	1	No

Thus there was no occasion when the SGF was utilised by the stock exchanges. They could complete the settlements due to prompt corrective measures adopted by them.

Investor Protection Fund

In case a stock broker is declared defaulter, the interests of the investors are protected through the Investor Protection Fund (IPF)/Customer Protection Fund (CPF) set up by the stock exchanges. At present, National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) are providing protection subject to a maximum of ₹ 15 lakh per client/investor. As on October 31, 2013, the corpuses of IPF at BSE, NSE and MCX-SX were ₹ 647.70 crore, ₹ 380.97 crore, and ₹ 10.89 crore respectively.

Securities Firms

3.68 As Securities and Exchanges Board of India (SEBI) is the regulator of the Indian securities market, it is vested with certain general powers and is responsible for regulation, registration, supervision of market participants, market surveillance, enforcement of the securities law, investors' education and protection and policy framework.

3.69 In addition to certain FMIs described above, SEBI regulates various types of entities that are fee–based and fund-based. For the fee-based entities that do not take deposits/funds from investors/public in general and whose operations are limited to particular clients, in the event of failure, the impact may not be widespread. For the fund-based entities, which manage public/third party funds, such as mutual funds, asset management companies, etc., there are provisions specific to each such regulated entity to ensure their smooth functioning.

3.70 Section 11B(iii) of the SEBI Act, 1992 empowers SEBI to issue directions, if it is satisfied that it is necessary to secure the proper management of any intermediary to protect the interests of investors in securities market and to ensure the orderly development of the securities market. Section 11(4) empowers SEBI to issue direction with pending enquiry/investigation.

3.71 SEBI has the power to direct transfer of clients/investors to other intermediaries in case of intermediaries who have been debarred or whose registration has been suspended or cancelled.

Power to appoint administrator/supersede the Board

3.72 In terms of the SEBI Act, 1992, SEBI is empowered to supersede the board and appoint administrators. In the past, SEBI has superseded the governing boards and appointed administrators in case of 6 stock exchanges. In case of CRB Mutual fund, based on the reports of financial irregularities by the sponsor, an administrator was appointed in the interest of unit holders.

Mutual Funds:

3.73 Asset Management Company (AMC) of a mutual fund needs to separately maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund. Thus, change in viability position of the sponsors of the Mutual Fund does not per se affect the interest of mutual fund unit-holders, as the assets of Mutual Fund are separately held by Trust and are kept in safe custody of custodians appointed by Trustees.

3.74 SEBI (Mutual Funds) Regulations, 1996 require quarterly review of the net worth of the asset management company by the trustees and in case of any shortfall, it is ensured that the asset management company makes up for the shortfall.

3.75 SEBI may direct winding up of a scheme of a mutual fund, in the interests of unit holders. The procedure for winding up including priority of claims is also mentioned in regulations. The proceeds of sale realised shall be first utilised towards discharge of such liabilities as are due and payable under the scheme and after making appropriate provision for meeting the expenses connected with such winding up, the balance shall be paid to the

unit holders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

3.76 The existing legal framework is inadequate to effectively resolve the above financial institutions in line with the FSB Key Attributes. The resolution framework for securities markets would need to take into consideration some factors[1], i.e. (i) the existing funds (Settlement Guarantee Funds and Investor Protection Funds) created in securities markets; (ii) the insurance schemes already prescribed by SEBI for different intermediaries; (iii) risk profiles of different types of intermediaries in securities markets; and (iv) international practices in securities markets in this area.

Pension Fund Sector

3.77 PFRDA currently regulates National Pension System (NPS) through its registered intermediaries like Pension Funds Managers (PFM), Central Record Keeping Agency (CRA), POP, Custodian, Trustee Bank, NPS Trust, Aggregators, etc. as per the agreement with these entities. However, Section 12(1) (A & B) of the PFRDA Act, 2013 provides for inclusion of any other pension scheme not regulated by any other enactment apart from NPS. The agreement with the institutions under NPS architecture is applicable to a particular legal entity and not to the institution's holding company or subsidiaries. The NPS is available to Indian citizens through the intermediaries in India only. As per Section 25 of the Act ibid, no pension fund shall directly or indirectly invest outside India, the funds of the subscribers.

3.78 PFRDA has the authority to monitor, take corrective action and also terminate the PFMs if they do not function as per the prescribed parameters to safeguard the interest of subscribers.

3.79 PFRDA is required to submit a report[2] to the central government where the affairs of CRA or Pension Fund are conducted in a manner prejudicial to the interest of the subscribers. The central government may consider the report and appoint Administrators. The central government may, on a complaint received by PFRDA or suo-motu, after conducting an enquiry, supersede the management/Board of the intermediary[3] and appoint an Administrator.

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[1] SEBI has requested to include these comments in the Report.
[2] Section 19(1) & (2) of PFRDA Act, 2013.
[3] Section 31 (2) of PFRDA Act, 2013.

Power to take over management

3.80 PFRDA can take over the Board/Management[1] of an intermediary after conducting an enquiry upon contravention of provisions of the Act

3.81 There are wide gaps in respect of resolution of problem or non-viable pension funds.

Resolution triggers

3.82 The Reserve Bank has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of three parameters, i.e. capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA), for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points. The PCA framework is applicable only to commercial banks and not extended to co-operative banks, non-banking financial companies (NBFCs) and FMIs. This framework is to essentially bring about timely corrective action in times of banks' failure to meet prudential requirements, or regulatory violations or the depositors' interest is threatened in any other way.

3.83 The RBI's regulatory guidelines on Basel III norms, applicable only to commercial banks, provides that a non-viable bank will be a bank which, owing to its financial and other difficulties, may no longer remain a going concern on its own, in the opinion of the Reserve Bank, unless appropriate measures are taken to revive its operations and thus enable it to continue as a going concern. The Point of Non-Viability (PONV) trigger event is the earlier of:

(a) A decision that a conversion or temporary/permanent write-off, without which the firm would become non-viable, is necessary, as determined by the RBI; and

(b) The decision to make a public sector injection[2] of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

3.84 However, these triggers are not specific to taking actions in crisis resolution.

3.85 Resolution powers of the IRDA are invoked when the apprehensions are raised through the following triggers:

[1] Section 31(2) of PFRDA Act, 2013.

[2] This action would imply that the write-off/conversion of non-equity regulatory capital instruments must occur prior to any public sector capital infusion.

(i) All insurers are required to be compliant with the solvency requirements as stipulated for insurance companies. The regulatory framework provides that each insurer shall maintain a solvency margin of 150% at all points in time. In case of an insurer's solvency falling below the stipulated requirement, the resolution trigger/ regulatory action would be triggered immediately. Under such circumstances, the IRDA would in the first instance require the insurance entity to take steps to restore the solvency margin.

(ii) The second trigger for such action could be the promoters of the institution being in financial difficulty and the insurer's financial condition being impacted as a result of the same.

(iii) The third trigger could be regulatory action against the promoter company by another supervisor (another sector regulator within the jurisdiction or by home country regulator in case of the JV partner).

(iv) The fourth trigger could be the insurance company continuously breaching the limits of expenses of management.

3.86 The above triggers do indicate certain pre-specified points, the breach of which would prompt the RBI and/or IRDA to take necessary regulatory action to avoid any further viability problems in the institutions. However, these are not clear triggers that would prompt the respective regulators to handover the problem institution to the resolution authority for initiating resolution actions. Even such a regulatory framework is practically absent in the case of other types of banks (i.e. co-operative banks, RRBs), FMIs and securities firms and pension funds.

Set-off netting, collateralisation, segregation of client assets

Bilateral netting and set-off on default of particular claim

3.87 The Contract Act, 1872 provides freedom to the contracting parties to structure their rights and obligations in the manner best suited for them, as long as such contracts are not unlawful or opposed to public policy. Thus, bilateral netting arrangement, including close-out netting contracts, on default of a particular claim would fall within the legal framework.

Bilateral netting and set-off on bankruptcy of a party

3.88 Section 47 of the Presidency Towns Insolvency Act, 1909[1] and Section 46 of Provincial Insolvency Act, 1920[1], provide that when there are mutual dealings between the

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[1]Presidency Towns Insolvency Act, 1909 govern the insolvency proceedings of individuals and partnership firms in presidency towns, i.e. Calcutta, Bombay and Madras.

insolvent and the creditor, set-off is permissible and sum due from one party shall be set-off against any sum due from the other party and the creditor may prove only the net balance due from the insolvent. Further, the Company Law provides that in the winding up of an insolvent company, the same rules regarding the (i) debts payable, (ii) valuation of annuities and future and contingent liabilities, and (iii) the respective rights of secured and unsecured creditors, shall prevail as in the case of law of insolvency relating to the insolvent persons. As the banking companies are registered under the Company Law, the same is applicable to private sector banks at the time of their winding up. As such, since the dealings between two banking companies would be mutual in nature, they can set-off the amount due between them and only the net amount would be claimed by the creditor bank from the liquidator of the banking company in liquidation without reopening the earlier trades between each of the members. However, this will hold good only for those banks and other financial institutions that are governed by the Company Law and the two insolvency legislations mentioned above.

3.89 The other banks (i.e. public sector banks and RRBs) that are statutory corporations (governed by their own statutes) and co-operative banks (governed by the respective State Co-operative Societies Acts and Multi-State Co-operative Societies Act, 2002) do not have similar provisions in their statutes permitting set-off of claims in liquidations.

Bilateral close-out netting

3.90 There are no specific provisions for close-out netting in the extant legal framework. However, even if the liquidator refuses to acknowledge the liability as a currently enforceable liability and treats it as a future liability, the fact that the debt has not matured when the insolvency commenced would not be of material consequence as the effect of the banking company's insolvency would accelerate the date on which the set-off should be effected and make the commencement of the winding-up/insolvency the time for that purpose. There are various court judgments[2] (Madras and Kerala High Courts) which had acknowledged that a debt, although not presently payable, can be set off against moneys owing to a company in liquidation. These are, however, applicable only for those banks, NBFCs and FMIs that are covered by the Company Law, the Provincial Insolvency Act, 1920 and the Presidency Towns Insolvency Act, 1909.

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[1] Provincial Insolvency Act, 1920 governs insolvency proceedings of individuals and partnership firms in other places.

[2] (i) K. Anantaraman v. Official Liquidator, Travancore National & Quilon Bank Ltd. reported in [1939] 9 Comp Cas 285 (Mad.); (ii) Isaac v. Palai Central Bank Ltd. reported in [1963] 33 Comp Cas 799 (Ker.).

3.91 Close-out netting of contracts in respect of co-operative banks would be governed by the provisions contained in the respective State Co-operative Societies Acts. Under the Maharashtra Co-operative Societies Act, 1960, the liquidator has the power to acquire custody and control of all actionable claims to which the society is entitled, on an interim order directing a society to be wound up. It also has the power to investigate all claims and decide on priority arising out of such claims and pay to any class of creditors in full or rateably according to the amount of such debts, compromise all debts and liabilities and all claims present or future, certain or contingent, subsisting or supposed to subsist between the society and contributory or other debtor, etc. on such terms as may be agreed. The close-out netting of contracts would, therefore, depend on the liquidator whose powers are subject to the control of the RCS.

Multilateral netting arrangements of banks

3.92 Multilateral netting takes place where clearing/settlement services are involved. Such payment systems are governed by the provisions of the Payment and Settlement Systems (PSS) Act, 2007. Section 23 of the PSS Act, 2007 overrides the provisions of Companies Act, 1956, BR Act, 1949 and all other Acts and confers settlement finality in the case of insolvency of a system participant. It provides that such insolvency shall not affect a settlement that has become final and irrevocable. Basically a netted settlement is final and irrevocable as soon as the money payable under that settlement is determined.

3.93 However, arrangements not governed by the provisions of PSS Act, 2007 would not get the benefit of multilateral netting arrangements. An FMI like CCIL has powers to close-out positions. Moreover, segregation of client assets is a part of extant regulations as is collateralization. Special provisions are being suggested to be provided by amendment to the PSS Act, 2007 for closing out position in the event of resolution of the FMI.

3.94 However, the extant legal framework, being not uniform for all banks and not providing specific provisions thus lacking clarity and transparency, falls short of the provisions contained in the FSB Key Attributes.

Temporary stay of early termination rights

3.95 The existing legal framework does not empower the regulators and/or the central government to impose temporary stay on exercise of early termination rights.

Safeguards regarding respect of creditor hierarchy

3.96 Though there are some provisions in the Company Law that provide seniority of claims in liquidation, it is not clear for other banks. However, the RBI's guidelines do indicate clear framework of creditor hierarchy in respect of failure of banks. In case of insurance companies, the scheme formulated under section 37A of the Insurance Act, 1939, to the extent that the assets are available over and above the liabilities of the regulated entity, the shareholders and creditors would get a share of such assets in case of winding up.

3.97 In case of acquiring of the undertakings of banking companies by the Central Government or transferring the same to any company established for the purpose or in any corporation, every person, in terms of Section 36AG of Banking Regulation Act, 1949, who, immediately before the appointed day, is registered as a shareholder in the acquired bank or, where the acquired bank is a banking company incorporated outside India, the acquired bank, shall be given by the Central Government or the transferee bank, as the case may be, such compensation as is determined in accordance with the principal contained in the Fifth Schedule of the Banking Regulation Act, 1949.

3.98 The Central Government or the acquiring insurer is required to make payment of compensation to the acquired insurer in respect of the transfer of the undertaking of the acquired insurer. The amount of compensation shall be decided by the central government or the acquiring insurer. If the amount of compensation is not acceptable to the acquired insurer, the matter shall be examined by the Tribunal, constituted for the purpose by the central government. The decision of the Tribunal shall be final.

3.99 There are, however, no clear legal provisions that indicate safeguards that should be provided to the creditors of the failing financial institutions in case of initiation of resolution actions/proceedings.

Protection by law from actions taken for complying with the decisions of resolution authority

3.100 Since the directions issued by the Reserve Bank are statutory in nature, the directors and officers complying with such directions would be acting as per the legal mandate. Unless they deviate from the directions in their actions, they would be getting protection available under law. Section 54 of the Banking Regulation Act, 1949 specifically provides that no suit or other legal proceedings shall lie against the Central Government, Reserve Bank of India or any officer for anything which is done in good faith or intended to be in

pursuance of the provisions of that Act. No claim for damages also would lie against them. There is a similar provision in the Reserve Bank of India Act, 1934[1].

3.101 No suit, prosecution or other legal proceedings shall lie[2] against the central government or any officer of the central government or any member, officer or other employee of the IRDA for anything which is done in good faith or intended to be done under this Act or the rules or regulations made thereunder. However, nothing in the Act exempts any person from any suit or other proceedings which might, apart from this Act, be brought against him.

Funding of firms in resolution

3.102 The extant legal framework does not provide for constitution of any resolution fund for use in resolving a failing financial institution, or for ex-post recovery of costs of providing temporary financing by the resolution authority to facilitate resolution.

3.103 However, the DICGC Act, 1961 provides for setting up an ex-ante deposit insurance fund by the DICGC. The fund is primarily sourced out of the insurance premia collected from insured banks (commercial banks including branches of foreign banks, co-operative banks, and RRBs), repayments received, coupon received from investment in central government securities, etc. The fund does not provide insurance cover to the depositors of NBFCs. The fund is used to make payments to the depositors in cases of amalgamation, reconstruction, compromises, arrangements and liquidation. The deposit protection provided by DICGC does not give any priority/preference to depositors of any insured banks, including branches of foreign banks functioning in India. However, the depositor protection is not provided to depositors of foreign branches of Indian banks. Moreover, the existing set up of DICGC does not permit the use of deposit insurance fund to finance non-payout resolutions.

3.104 In case a stock broker is declared defaulter, the interests of the investors are protected through the Investor Protection Fund (IPF)/Customer Protection Fund (CPF) set up by the stock exchanges. At present, National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) are providing protection subject to a maximum of ₹ 15 lakh per client/investor. As on October 31, 2013, the corpuses of IPF at BSE, NSE and MCX-SX were ₹ 647.70 crore, ₹ 380.97 crore, and ₹ 10.89 crore respectively.

[1]Section 58A of RBI Act, 1934.
[2] Section 22 of IRDA Act, 1934.

Non-discrimination among creditors on the basis of nationality, location of claim etc.

3.105 The deposit insurance system operated in India by the DICGC provides for payment to the eligible depositors of insured banks located in India, including the foreign bank branches located in India. The depositor protection/ insurance is, however, not provided to depositors of foreign branches of Indian banks by DICGC. In terms of Section 21 (2) of DICGC Act, 1961, DICGC has a first claim on bank's liquidated assets up to the amount paid to the depositors. Since the depositors of foreign branches of Indian banks are not insured by DICGC, and further that the DICGC has a first claim on bank's liquidated assets, the regime indirectly provides for a preferential treatment to the depositors of bank branches in India as compared to the depositors of branches of Indian banks situated in other countries.

3.106 In terms of Section 11(4) of the BR Act, 1949, in the event of a foreign bank ceasing to carry on banking business in India, the minimum paid up capital and reserves which it is required to maintain under Section 11(2) of the Act ibid shall be an asset of that company on which the creditors of the company in India shall have first charge. This, however, talks only about the capital and reserves kept with the Reserve Bank. The proceeds from other assets have to distributed as per the provisions of the Companies Act, which do not discriminate on the basis of nationality, location of claims or the jurisdiction where it is payable.

Information sharing and cross-border cooperation

3.107 There is no specific statutory provision enabling or prohibiting the Reserve Bank or the central government from cooperating with foreign resolution authorities. Further, Indian law does not specifically recognize foreign bankruptcy proceedings. However, Indian Courts on reciprocity basis recognize the decrees passed by the foreign courts, subject to the exemptions provided in Section 13 of the Code of Civil Procedure, 1908 ("CPC"). In terms of Section 44A of CPC, the certified copy of a decree passed by a foreign court of any reciprocating territory has to be filed in a District Court and such decree may be executed in India as if it had been passed by the District Court.

3.108 Further, Section 45E of the RBI Act, 1934 prohibits the Reserve Bank or any banking company from disclosure of credit information, except in the following circumstances:

(i) The disclosure by any banking company with the previous permission of the RBI of any information furnished to it under Section 45C;

(ii) Publication by RBI of any information collected by it under Section 45C in such consolidated form as it may think fit without disclosing the name of any banking company or its borrowers in the public interest;

(iii) The disclosure or publication by the banking company or RBI of any credit information to any other banking company or in accordance with the practice and usage customary among the bankers or as permitted or required under any other law; and

(iv) Disclosure of any credit information under the Credit Information Companies (Regulation) Act, 2005.

3.109 Presently, the RBI has been engaging in Memorandum of Understandings (MoUs) with various Central Banks with a view to promoting greater co-operation and sharing of supervisory information between the supervisors. So far, the Reserve Bank has signed 19 MoUs with regulators of various jurisdictions. However, the present approved MoU framework does not envisage/provide for cooperation, coordination and exchange of information between/amongst resolution authorities or for crisis resolution.

3.110 IRDA has become a signatory to the Multilateral Memorandum of Understanding (MMOU) of International Association of Insurance Supervisors (IAIS) which provides an international platform for cooperation and sharing of information. The IRDA (Sharing of Confidential Information Concerning Domestic or Foreign Entity) Regulations, 2013 are in place, which provide for the manner in which/bodies with which confidential information can be shared. The MMOU with the IAIS also provides a framework for enhanced supervisory cooperation between the supervisory authorities and has also envisaged/provided for cooperation, coordination and exchange of information including in case of winding up, liquidation and bankruptcy and administration of guarantee funds.

3.111 However, the present approved MoU framework for banks for enhanced supervisory cooperation between the domestic regulatory/supervisory authorities and foreign authorities, does not envisage/provide for cooperation, coordination and exchange of information between/amongst "resolution authorities" or on crisis resolution.

Recovery and Resolution Planning and Resolvability Assessments

3.112 Though there are various domestic financial institutions that could be considered as systemically important and that can impact the financial stability of the country, they are not mandated by the regulator or the supervisor to prepare recovery and resolution plans.

Moreover, presently, neither the respective regulators nor the central government assess and evaluate the feasibility and credibility of resolution strategies for Indian financial institutions. The assessment is also not conducted for the financial conglomerate/groups.

3.113 However, the frameworks for "Regulation and Supervision of Financial Market Infrastructures regulated by RBI as well as by SEBI" have been issued in July 2013. Accordingly, all FMIs have to comply with the Principles of Financial Market Infrastructures (PFMI), which includes putting in place a Recovery and Resolution Plan.

Crisis management groups and Institution-specific cross-border cooperation agreements

3.114 Presently, the Indian financial institutions do not qualify for classification as G-SIFIs. However, 15 of the 29 G-SIBs and eight out of thirteen Global Systemically Important Insurers (G-SIIs) have presence in India in the form of branches/joint ventures. The responsibility for constituting the CMGs for G-SIFIs lies with the home resolution authority. So far, no CMGs have been constituted by the Indian authorities in respect of financial institutions that have foreign presence. So far, India has not signed any cross-border cooperation agreements for resolution of G-SIFIs.

Problems in Financial Institutions in India

Problems in banks

3.115 In India, during the past decade nine commercial banks[1] were voluntarily amalgamated and five banks[2] were compulsorily amalgamated. There has been no case of liquidation of commercial banks during the last two decades, except for Bank of Karad in 1992, a part of which was later sold to another bank (Bank of India).

3.116 Private sector banks that demonstrated signs of weakness were compulsorily amalgamated with other strong banks in a timely manner in order to protect the interests of

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[1] (i) IDBI Bank Ltd. merged with IDBI Ltd. on April 2, 2005; (ii) Bank of Punjab Ltd. merged with Centurion Bank Ltd. on October 1, 2005; (iii) Sangli Bank Ltd. merged with ICICI Bank Ltd. on April 19, 2007; (iv) Lord Krishna Bank Ltd. merged with Centurion Bank of Punjab Ltd. on August 29, 2007; (v) Centurion Bank of Punjab Ltd. merged with HDFC Bank Ltd. on May 23, 2008; (vi) Bank of Rajasthan Ltd. merged with ICICI Bank Ltd. on August 12, 2010; (vii) State Bank of Saurashtra merged with State Bank of India on August 2008; (viii) State Bank of Indore merged with State Bank of India in July 2010; and (ix) SBICI Ltd. merged with State Bank of India on July 2011.

[2](i) Benares State Bank Ltd. (BSBL) amalgamated with Bank of Baroda on June 19, 2002; (ii) Nedungadi Bank Ltd. amalgamated with PNB on February1, 2003; (iii) Global Trust Bank merged with Oriental Bank of Commerce on August 14, 2004; (iv) Ganesh Bank of Kurundwad Ltd. amalgamated with the Federal Bank Ltd. on September 2, 2006; and (v) United Western Bank Ltd. amalgamated with IDBI Bank Ltd. on October 3, 2006

depositors. However, these compulsory amalgamations took place only upon valuation and assessment by the transferee bank and did not involve any regulatory forbearance from RBI. The transferee banks took over the entire liabilities of the transferor bank, either on the assessed value or at a discount with the DICGC having to pay certain amount (in one case), or even made an upfront payment to the shareholders of the transferor bank (in one case). The compulsory amalgamations during the last decade have helped in avoiding liquidation of commercial banks that may have resulted in payments by DICGC and loss to the depositors. The resolution process adopted in respect of the above-mentioned five banks is given in brief in **Box 3.2**.

BOX 3.2

Problems in banks in India – Use of resolution powers and tools

The Benaras State Bank Ltd. (BSBL), a scheduled commercial bank with a network of 100 branches, had several deficiencies in the areas of credit management and funds/investment management. The bank's net worth had eroded and its CRAR had turned negative. In order to prevent any run on the bank, RBI issued directions under Section 35A of the B. R. Act, 1949 placing restrictions on the functioning of the bank. Meanwhile, the valuation of assets and liabilities of the bank was done by an independent firm of Chartered Accountants. The valuation ascertained the pro rata share at 85.85% and eligible depositors' accounts were credited with a sum equal to 85.85% of the value of their deposits. The DICGC had to settle the claims to the extent of ₹ 99.00 crore on amalgamation of the bank. Finally, in terms of Government notification, Benares State Bank Ltd. (BSBL) was amalgamated with Bank of Baroda on June 19, 2002. While in the resolution process, there was no regulatory forbearance granted to the transferee bank, there was no loss to the depositors and the employees of the transferor bank. However, the shareholders of the transferor bank suffered the loss.

The Nedungadi Bank Ltd., a scheduled commercial bank with a network of 171 branches, was engaged in 'arbitrage trading in shares' through three broking firms, which envisaged simultaneous purchase and sale of shares on different stock exchanges to take advantage of the price difference. With the stock market crash in 2000 and high level of NPAs (gross NPA and net NPA at 41.3% and 26.0% respectively), the bank's CRAR and net worth turned negative as on September 30, 2001 at (-) 5.63% and (-) ₹ 45.56 crore respectively. The Chairman of the bank, being the approving authority for all such transactions, was removed by the RBI in terms of Section 36AA of BR Act, 1949, and a new Chairman was appointed. The assessment of the provisional results revealed a requirement of fresh infusion of capital of ₹ 112 crore and ₹ 170 crore to cleanse the balance sheet. Considering the bank's adverse financial position, it was considered doubtful of raising capital by a public issue, as well as the feasibility of voluntary merger. Finally, the RBI recommended to the central government for placing the bank under moratorium, and was amalgamated with Punjab National Bank with effect from February 1, 2003. This resolution process did not envisage any loss to the depositors and the employees of the bank, as also did not involve DICGC participation. The process did not provide any regulatory forbearance to the transferee bank, but the shareholders of the transferor bank suffered the losses.

The Global Trust Bank Ltd. (GTB), a scheduled commercial bank with a network of 104 branches, had a very high capital market exposure and high level of NPAs. Noticing an unusual rise in share price (34.86%) of GTB as compared to bank index (4.78%) and BSE Sensex (5.4%), RBI requested

SEBI in November 2000 to make detailed enquiries. Quick scrutiny by RBI revealed various deficiencies in capital market exposure, NPA and CRAR. The bank was put under monthly monitoring and was asked to draw up action plan to bring improvements in its functioning within a time frame of six months. The bank was also asked to submit a concrete time bound action plan to reduce its exposure to capital market to 5% by March 31, 2002. As directed by BFS, RBI undertook, through auditors, an independent assessment of quality of assets and determine true financial position. On the basis of the assessment, the bank was issued a set of directions relating to lending, declaration of dividend, capital market exposure, etc. Due to non-improvement and further deterioration of bank's financial position, RBI placed the bank under moratorium and was finally merged with Oriental Bank of Commerce (OBC) in terms of Section 45 of BR Act, 1949. The merger was kind of a private sector purchase by OBC and there was no loss to the insured depositors as well as employees of the transferor bank and no involvement of DICGC insurance fund.

Ganesh Bank of Kurundwad Ltd., a scheduled commercial bank with a network of 32 branches, had very low capital base with high NPA level and negative networth. The bank was initially put under monthly monitoring system and subsequently was advised to take structured actions under Prompt Corrective Action (PCA) framework as its NPA had hit the trigger point of above 10%. With signs of weaknesses in the bank's financials in terms of high gross NPA and negative networth, the RBI placed the bank under Moratorium for a period of 3 months and prepared a draft Scheme of Amalgamation of Ganesh Bank of Kurundwad Ltd. with the Federal Bank Ltd. which had forwarded its expression of interest and sought no regulatory forbearance on amalgamation. However, due to court cases and litigations, the amalgamation could not be effected on the Government notified date. On resolution of the court cases, the bank was finally amalgamated with Federal Bank Ltd on January 24, 2006. This process of amalgamation, though did not envisage any loss either to the insured depositors and employees of the transferor bank and to the DICGC Insurance Fund, indicated a requirement of a special resolution regime for banks with sufficient tools and powers to the resolution authority and without the court process and shareholders' approval.

United Western Bank Ltd., a scheduled commercial bank with a network of 230 branches, had poor financials in various parameters such as, negative CRAR, high level of NPAs, high cost deposits, etc. Accordingly, the bank was placed under monthly monitoring. With no improvement in the bank's financials inspite of close monitoring and issuing of directions, and unsuccessful raising of capital through rights issue, RBI applied to the Central Government for placing the bank under moratorium and prepared a scheme of amalgamation. Among the various Expressions of Interest (EOIs) received, IDBI Bank Limited's proposal was accepted as the proposal provided for payment to depositors in full, it did not seek any regulatory forbearance and provided for an upfront payment of ₹ 28 per share to the transferor bank's shareholders. The bank was finally amalgamated with IDBI Bank Ltd. on October 3, 2006.

Problems in insurance companies

3.117 Post opening up of the insurance sector to private participation in 1999, there have been no instances of failure of an insurance company in India. There have, however, been instances where the regulator (IRDA) has intervened to address industry wide/individual company related concerns which could have had implications for the industry as a whole given the nascent stage of the industry and the concerns for the health of the industry.

3.118 Until May 2013, insurers were permitted to have representative/liaison offices outside India. Exception to this requirement was public sector insurers that had presence in foreign

countries in the nationalized set up, prior to the opening up of the sector in 1999. Effective from May 2013, Indian insurance companies are permitted to open foreign insurance company (including branch office) outside India. Simultaneously, Section 34G of the Insurance Act, 1938, empowers IRDA to order for closure of any branch outside India of an insurer if it has reason to believe that the working of that branch is generally resulting in a loss or that the affairs of that branch are being conducted in a manner prejudicial to the interests of the policy-holders or the public interest within such period, not being less than one year. The IRDA is also empowered to intervene, where considered necessary to address a deteriorating portfolio of business. Brief of two cases of problems in insurance sector are provided in **Box 3.3**.

BOX 3.3

Problems in insurance companies in India – Use of resolution powers

National Insurance Company Ltd. – Hong Kong Branch

The National Insurance Company (NIC), the oldest insurance company in India incorporated in 1906, started functioning as a subsidiary of the General Insurance Corporation of India from 1972 when its services were dedicated to the nation by the General Insurance Business Nationalisation Act. The NIC, till 2002, had operations in two foreign markets (Nepal and Hong Kong) through local branches. In Hong Kong, business came mainly from Motor and Extended Coverage/Employer Liability Policies, where chances of occurrence of losses are comparatively more than other types of insurance business. The Hong Kong branch posted net losses for the years 2001-02 and 2002-03. Consequently, it had stopped accepting new insurance business in Hong Kong with effect from February 18, 2002. However, the branch continued servicing the policies in force. The operations were discontinued and went into run-off portfolio to facilitate settlement of liabilities. The run-off operations were handed over to New India General Insurance Company Ltd. through creation of an escrow account. The arrangement continued as a pure run-off operation until the entire outstanding liability was paid off.

AMP Sanmar Life Insurance Company Ltd.

AMP Limited of Australia and Sanmar Group, formed a joint venture to carry on life insurance business in India. AMP Sanmar Life Insurance Company Ltd., was granted registration by the Authority to undertake life insurance business on 3rd January, 2002. The company commenced underwriting policies in a small way in the financial year 2001-02 with first year premium of Rs.27.73 lakh going up to Rs.91.33 crore in 2004-05. Following AMP's decision to stay focused on its core wealth management business in Australia and New Zealand and keep its Asian focus centred in asset management through AMP Capital investors, AMP Limited decided to sell its stake in the joint venture and concurrently Sanmar decided to take advantage of the opportunity to review its stake in the business.

When the IRDA was apprised of the intent of the promoters to effect changes in the ownership structure for obtaining necessary permission, the prime concern of the regulator was to ensure that the interests of policyholders continues to be protected and all the extant commitments made by the company continues to be honoured in the normal course despite ownership changes. It was also clear that the process of change in ownership would necessarily involve a time lag during which various options for the restructuring of the company had to be explored to the satisfaction of all concerned. The company was asked by IRDA to establish regular weekly reporting systems to closely monitor the

developments to safeguard the interests of the policyholders. Restrictions were placed on major expenses and in particular on capital expenditure, changes in the Board of Directors and on the various committees of the Board, and any measures which could possibly weaken the company. The management was not permitted to take any policy decision which could have ramifications on the functioning of the company without the explicit concurrence of the IRDA.

Though in the initial few days after the announcement by the insurance company, there was a noticeable uptrend in redemptions combined with a slow down in the new premium underwritten, the anxiety of policyholder on the future of the company reduced after the IRDA assured through the media that the interests of the policyholders would be fully protected as the company was compliant with the stipulations on solvency requirements.

Since the process of amalgamation as laid down in the Act was long drawn, the IRDA pursued with the owners other options to ensure that the identity of the insurance company was retained and those parties which were interested in acquiring the stake of the promoters could be short listed.

Consequently the promoters entered into an agreement on 31st July, 2005 for sale of their 100 per cent holdings to Reliance Capital Ltd. (RCL) and sought regulatory approval for the proposal. The Authority carried out the due diligence of RCL, a Non-Banking Finance Company (NBFC) registered with the Reserve Bank of India (RBI), in consultation with other regulators and looked specially into the capability of the company to carry life insurance business, its ability to honour all the commitments made to the policyholders and to inject funds at periodic intervals to meet the requirements of capital funds. On being satisfied the IRDA granted approval to the transfer of shares on 29th September, 2005. The new promoters affirmed, through the media, their commitment to honour all policyholders' contracts and the insurer continued its normal activity without any restrictions thereafter.