Reserve Bank of India

Report of the Informal Working Group on Reforms in the Insolvency Resolution Regime for the Indian Financial System

July 29, 2003
Mumbai

मु. र. कोलारकर
विधि परामर्शदाता
S. R. KOLARKAR
LEGAL ADVISER

भारतीय रिज़र्व बैंक
विधि विभाग
केन्द्रीय कार्यालय,
शहीद भगतसिंह मार्ग,
मुंबई -400 001, भारत.
RESERVE BANK OF INDIA
LEGAL DEPARTMENT
CENTRAL OFFICE,
SHAHID BHAGAT SINGH ROAD,
MUMBAI - 400 001, INDIA.

July 29, 2003

Dear Sir,

**Report of the Informal Working Group on
Reforms in Insolvency Resolution Regime
for The Indian Financial System**

We have pleasure in forwarding a copy of the Working Group's Report on the above subject for kind perusal.

S.R. Kolarkar
Chairman

K.V. Rajan
Member

Narendra Jadhav
Member

R. Gandhi
Member

Anand Sinha
Member

O.P. Aggarwal
Member

C.R. Muralidharan
Member

K.U.B. Rao
Member-Secretary

To
Dr. Rakesh Mohan,
Deputy Governor,
Reserve Bank of India,
Central Office
Mumbai.

Preface

Recent developments in the international financial environment, notably the increasing integration of the financial markets and emergence of large participants whose financial activities span across continents have brought to the fore a host of complex issues such as conflicts over legal jurisdictions, opportunities for legal arbitrage and associated possibilities for systemic risk in the financial markets. The issue of speedy, efficient and equitable resolution of insolvency in the financial sector assumes critical importance in the emerging milieu. A number of international initiatives by both official agencies and market participants have been undertaken towards reforming the existing insolvency regimes.

Leading multilateral institutions like the World Bank and the International Monetary Fund have taken up important initiatives in respect of insolvency reforms. One such international initiative was the Report prepared by the 'Contact Group on Insolvency Arrangements and Contract Enforceability' constituted by the G-7. The contents and findings of the Report are relevant for initiating insolvency reforms in emerging market economies that are in the process of opening up their economies. The key message of the Contact Group's Report is that there is an urgent and imperative need to undertake a thorough review of the existing legal framework related to insolvency and bankruptcy and overhaul the same in tune with the requirements of increasing integration of the global financial systems so as to insulate the market participants from the risks of cross boarder insolvency. Such a step would help minimize systemic risk and enhance confidence in the domestic financial system, facilitating thereby greater flow of foreign investment.

Considering the importance of the subject and the need to review the extant position of India with reference to the major findings of the Report, Reserve Bank of India has decided to constitute an informal "Working Group on Insolvency Regime for Banks and Financial Institutions in India".

The Group will have the following broad terms of reference:

a. The broad objective of the Working Group is to study the status of the Indian insolvency procedures for banks and financial institutions in the context of the issues raised in the Report of the Contact Group;

b. To suggest measures that could be taken up in the short-run to the Management of the Bank;

c. To indicate issues/action points that RBI may have to bring to the notice of the Government of India; and

d. To identify issues on which further work has to be undertaken over time.

Keeping in view these terms of reference, the Working Group is expected to examine issues such as: the need for considering a special financial and bank insolvency law in India; the feasibility and desirability to have broad harmonization of the Indian insolvency framework with others; the possibility of implementing speedy and market based insolvency mechanisms as explained in the Report; identifying the current impediments to widespread use of financial arrangement like 'securitisation'; the need for a review the role of RBI as the regulator of the financial system and as the initiator of insolvency proceedings for the entities in the financial system; the adequacy of existing 'exposure norms' to minimize the extent of insolvency; the impact of financial integration on insolvency; and the reforms required with reference to cross border insolvency and other relevant issues.

Shri S.R.Kolarkar, Legal Adviser, was the Chairman of the Working Group. Other Members include Shri Anand Sinha, Chief General Manager, Deposit Insurance and Credit Guarantee Corporation, Dr. Narendra Jadhav, Officer-In-Charge, Department of Economic Analysis and Policy, Shri C.R.Muralidharan, Chief General Manager, Department of Banking Operations and Development, Shri C.S.Murthy, Chief General Manager-In-Charge, Department of Non-banking Supervision, Dr. K.V.Rajan, Chief General Manager, Urban Banks Department and Shri R.Gandhi, Chief General Manager-In-Charge, Department of Information Technology. Consequent to the transfer of Shri C.S.Murthy from the Department of Non-banking Supervision, his successor Shri O.P.Aggarwal has been included as a Member in the Working Group. Shri K.U.B.Rao, Director, Division of International Economic Relations, Department of Economic Analysis and Policy was the Member Secretary to the Working Group. The Working Group submitted the Report on July 29, 2003.

The Working Group has met three times. It has deliberated on the important contents and major findings of the Report of the Contact Group. From among the issues raised in the Report of the Contact Group, such of those issues that have a relevance for the Indian financial system have been examined by the Working Group keeping in view the broad terms of reference assigned to it. The Working Group's Report is organized into three sections. Section I is an introductory chapter, which explains the background and the relevance of the subject matter to the central banks; Section II deals with various issues on which the Working Group deliberated and offered certain recommendations; and Section III provides a summary of the recommendations. Annex I contains a summary of the Report of the Contact Group. The Working Group is highly grateful to Shri N.V.Deshpande, Principal Legal Adviser for his guidance. The Working Group acknowledges the assistance received from Dr. N.Krishnamohan, General Manager, DBOD, Shri S.Pattanaik, Assistant Adviser, DEAP, Shri V. Surelia, Assistant General Manager, DIT, Shri V.R.Prasad, Legal Officer, Legal Department and Shri N.Nambiar, Manager, DICGC.

SECTION - I

Introduction

Insolvency regime, which is a part of the wider framework of law by which society is governed and regulated, cannot be static in an environment, which is dynamic and constantly evolving. There is an imperative need for a process of reassessment at regular intervals to ensure that the law is in touch with evolving realities and social needs. While it should be the objective of any legal reform process to identify what is internationally regarded as the current standard of best practice and to weave that into the extant system for which they are accountable, they must necessarily have regard to the practical realities of the system itself. The final choice invariably has to be a reflection of what is realistically attainable within the system. It is widely recognized that there is a need to integrate insolvency law into the broader legal, commercial and socio-political context of a country. While the basic focus is on how best to serve the interests of a society, it is unrealistic to ignore the wider global context in which trade and commerce take place. Any reform contemplated should not ignore the strong international influences that drive the global markets and competition in those markets by accommodating various issues arising in the insolvency resolution context.

Insolvency law becomes more important when a society adopts a market economy and faces the concomitant problems created by market risk. Insolvency law is important to allocate the costs of failure fairly in relationship to the economic responsibility of each actor and to avoiding the fraudulent shifting of consequences from those upon whom the market risk should fall. That discipline contributes importantly to the long term strength of the market. One of the functions of insolvency law is to impose social order, and to do so rapidly. Insolvency law does not operate in a vacuum, but as part of a country's commercial law framework. In order to be effective the law must be part of a functioning insolvency system. While each country should primarily tailor its insolvency laws to fit its domestic needs it must, in today's environment pay heed to standards, which are required by the international community.

Need for a review of domestic insolvency framework

Insolvency legislation is a fundamental component of the institutional framework in every market economy. It is the main tool for imposing financial discipline and a hard budget constraint on enterprises; it provides a mechanism for an orderly enforcement of creditor rights and the restructuring or liquidation of the debtor. However, the rapid change in the economic environment has rendered many normative approaches that are often used as models as obsolete. In some jurisdictions, the enforcement of creditor rights is "sacrosanct"; the result might be a net transfer of wealth from junior to senior creditors and a net increase in social costs, resulting from the unwarranted demise of a going concern with a positive present value. In contrast, some countries have adopted rules that primarily focus on debtor protection. This might increase credit risk and shield inefficient management from a much-needed change.

Recent international experiences towards insolvency reforms

Considerable work has been initiated by international bodies, which are relevant to the intended reform of insolvency laws in all the countries. Among others, reports have been prepared by the IMF, the World Bank, the United Nations Commission on International Trade Law (UNCITRAL) and the Asian Development Bank (ADB). These international reports have stressed the need for strong insolvency systems to act as important pillars of support for the financial system as a whole and the efficient flow of international capital in particular. The Report of the International Monetary Fund (IMF) on Insolvency says that *"over the years, the IMF has become increasingly involved in the promotion of orderly and effective insolvency systems among its members. Experience has demonstrated that reform in this area can play a major role in strengthening a country's economic and financial system. Insolvency reform can be particularly relevant for economies in transition, where it can play a critical role in addressing the problems of insolvent State-owned enterprises"*. Similarly, the World Bank, in a consultation draft, 'Effective Insolvency Systems' says that *"as globalization redefines commercial expectations and relationships, the challenge is to reinvigorate insolvency systems to promote restructuring of viable businesses and the efficient closure and transfer of assets of failed businesses. Therefore, it is necessary that sound insolvency laws should be developed during good times for the purpose of dealing with the inevitable cycle of adverse economic cycle"*.

The current debate - Factors for and against insolvency reforms

There is a need to find a fresh approach to both domestic and cross-boarder insolvency law, which deals adequately with certain concerns like the impact of liberalization and integration on the extent of insolvency, impact of general insolvency on the financial sector, provision of functional responses to today's international context of trade and commerce in which cross-border problems arise, provision of effective and fair remedies in civil disputes where those disputes spill over national borders and resolution of the otherwise irreconcilable conflicts between national legal systems and to ensure that justice is ensured among various classes of creditors.

Factors in favour of insolvency reform:

One factor in favour of the insolvency reforms is the globalization trend factor. This factor recognizes that consistent commercial laws are required to meet the challenges presented by the border-less global economy. The second is the fiscal factor. This is concerned with the fiscal consequences to the economy, which insolvency reforms may cause. If the insolvency reforms are strong, timely resolution of insolvency of the loss making public sector undertakings would reduce the pressure on fisc. The other factor in favour of reform is efficiency and fairness factors. These factors relate to the desirability of finding practical solutions, which will avoid unnecessary, yet intricate, legal arguments on cross-border insolvency.

Factors that weigh against reform:

One critical argument against the insolvency reform is the sovereignty factor. The desirability of a country having a regime, which may better suit or protect local creditors and therefore it need not go for a reform. An argument against adoption of any model law is the need to preserve sovereignty to legislate as it thinks fit in respect of assets situated in a country. But, such an approach would be territorialist in nature and may act as a disincentive to foreign investment. Needless to stress that a territorial approach is outweighed by the disadvantages, which would flow from it. A global economy does exist of which every country is part. It is unrealistic and undesirable for a country to legislate its insolvency laws in a manner inconsistent with global commercial trends.

Need for an Informal RBI Working Group

Recently, on the initiative of the Bank of Italy the G10 commenced deliberations on certain issues raised by the increasing integration of international financial markets and the emergence of large players whose financial activities span many countries and jurisdictions, for the operation of one important component of the legal system, namely insolvency law. A Contact Group composed of interested countries and institutions took up this review. Participants have included representatives from Italy, Japan, the Netherlands, the United Kingdom and the United States, as well the BIS, ECB, IMF, OECD and World Bank. This Group is known as the Contact Group on the Legal and Institutional Underpinnings of the International Financial System, which prepared the Report on Insolvency Arrangements and Contract Enforceability.

The aim of the Report is to stimulate interest for further reflection on a range of insolvency related legal policy issues. The Report pursued the objectives by identifying current trends in the area of insolvency laws, by discussing some problems created by the growing integration of financial markets and by pointing to some areas where gaps or frictions seem likely to emerge or have already emerged. The Report was released for public discussion in September 2002.

The contents and the findings of the above Report need to be considered against the changing scenario in the global financial markets and its implications for insolvency resolution. A corpus of law governs the financial transactions in every country, which specifies the nature of the financial contracts and provides mechanisms for seeking redress in the event of a failure to perform. Such law in each economy aims at striking a balance among certain broad domestic objectives, which are yet times conflicting in nature. It is also likely that the objectives of domestic legislation vary from jurisdiction to jurisdiction and therefore lacks coherence across jurisdictions.

An important characteristic of today's international financial landscape is a marked increase in the integration among financial markets. Such financial integration leads to valid trepidation and raises issues like creation of policy-relevant frictions due to diversity and incompatibility, risk of legal arbitrage among jurisdictions and a possibility of negative externalities in the form of spillover and contagion effects. Market practitioners have over the years tried to fill some of the gaps by developing a set of practices, conventions, and customs to reduce the risks associated with international financial transactions. It is doubtful that such a "flexible law" can provide an effective hedge to the existing and emerging needs of a global financial marketplace. Therefore, several international financial institutions and other international organizations have launched initiatives to bring in reforms in the legal field by identifying the basic building blocks of a satisfactory legal system and suggesting a "minimal harmonization" of national practices through a set of principles and sound practices to strengthen their domestic institutional setup.

It is considered appropriate at the present juncture to survey the work undertaken so far by the various institutions and agencies to identify the possible gaps and areas of overlap; to take stock of the lessons of the recent crisis episodes for the benefit of the reform process; to deepen the authorities' knowledge of the "soft law" currently in place highlighting the possible negative aspects; and to identify a possible role for international groups, such as the G10 or the G20, in promoting strong and dependable legal institutions and practices relating to financial transactions.

Against this background, it is believed that the time is apposite to take review of the extant Indian position with regard to the extant legal framework related to insolvency resolution with specific focus on the financial sector insolvency and general insolvency to the extent it has an impact on the Indian financial system. The terms of reference assigned this Working Group broadly warrants a study of the contents and findings of the Contact Group's Report on Insolvency Arrangements and Contract Enforceability in so far as their applicability to the Indian financial system is concerned. A gist of the contents and major findings of the Contact Group's Report on Insolvency Arrangements and Contract Enforceability is provided in Annex I. Annex II provides information on insolvency related provisions in various Statutes related to banks and other financial institutions.

Why insolvency reforms are relevant to Central Banks?

The impact of corporate sector insolvency has a crucial bearing on the health of the financial system. Due to the increasing financial liberalization and integration, when the entry and exit norms are relaxed and unviable entities have to cope with the efficient entities from abroad, it is likely that some of the inefficient entities may have to cease to operate with its attendant impact on the insolvency. This obviously results in problems for the financial system with exposure to some of these inefficient entities. Likewise the liberalization of the entry and exit norms for the financial sector entities in the emerging economies will have a similar impact on some of the inefficient financial sector entities. As such, at least in the short to medium term the impact of liberalization on the degree and extent of insolvency cannot be wished away. So, the Central Bank of a country needs to be vigilant about the trends in corporate sector financial health, insolvency in the corporate sector and its implications to the financial sector. Likewise, the health of the financial system, the impact of opening up of the financial system to foreign competition and its consequences to insolvency in financial system needs careful monitoring by the Central Bank. Considering fact that, the evolving trends in the international financial markets are pointing to the need for jettisoning the antiquated insolvency-related legal systems in most of the emerging countries, there is an imperative need to the Central Banks to take initiative in studying the insolvency regimes elsewhere, developing best practices and standards and advise the Government on the adverse implications of archaic insolvency procedures to the health of the economy in general and to the financial sector in particular. As the insolvency in financial system will have disastrous consequences to the whole economy, any lax and slipshod attitude to this critical element in the legal system of an economy will be dangerous to the whole system. The initiatives taken by the multilateral agencies like the IMF and World Bank have created awareness among the authorities and stimulated discussions on this subject in the past few years. The fact that the Central Banks world over have accepted implicitly or explicitly the objective of ensuring 'orderly conditions' in the financial markets to ensure 'financial stability' provides the justification for its indulgence in this hitherto neglected area of insolvency reforms.

The Reserve Bank of India's interest in bankruptcy legislation is directly linked to its institutional role as supervisor of the banking system because of the important role of banks in financing economic enterprises. Efficient bankruptcy procedures mean a prompt liquidation to eliminate "bad" credits from banks' balance sheets, thus contributing to their stability. As explained earlier, bankruptcy law directly impacts the efficiency of the economic system since it extends not only to large businesses but also to small and medium enterprises. Any problems affecting large or medium or small businesses will directly affect the livelihoods of employees at all levels.

SECTION II

The Working Group has deliberated on various issues like the need to review the current issues in insolvency resolution in the Indian financial system; the need for a special and distinct insolvency regime for the Indian financial system; the need to ensure that the insolvency regime for the financial system should be, efficient, expeditious and equitable; the need to ensure that the insolvency estate should be maximized through various means; the need to ensure that the collateral is liquidated rapidly to avoid asset value erosion; the need to clearly specify the distribution pattern of insolvency asset while giving priority to depositors among the unsecured creditors; whether the Indian insolvency framework should aim at 'harmonization' with other countries' regimes or international reports on insolvency and the impact of financial integration on insolvency in the financial system. **The issues examined and the recommendations offered have been categorized into a set of operational and general issues.**

A. OPERATIONAL ISSUES

Issue 1 - Impact of corporate sector distress on the financial system

In the emerging markets, economic crises are often systemic in nature, leading to a need for restructuring in both the financial and real sectors. The Working Group recognizes the serious impact of corporate insolvency on the health of the financial system. Following a financial crisis in an emerging market, governmental or quasi-governmental bodies may find themselves holding sizeable distressed debt portfolios as a result of bank recapitalisation or closure programmes. This creates a need for a co-ordinated approach to real and financial sector restructuring that can be difficult to address solely in the context of informal debt restructuring negotiations.

Therefore, there is a clear need for choosing a balance between real and financial sector restructuring. Where an economic crisis involves both the banking and corporate sectors, government asset management units will inherit distressed debt positions as a result of bank takeover or recapitalisation programmes. The manner in which these positions are handled by the government is of critical importance to real sector debt restructuring. It is necessary to recognize the fact that financial sector restructuring cannot solely come at the expense of the real sector. From the societal view, governments are better served by encouraging broader corporate sector recovery. There are two reasons for this. First, by favouring corporate sector recovery, a country's employment base is preserved and tax revenue is maximized. This will also result in increased debt service capacity as companies are restructured.

The Working Group has taken note of the steps that have been initiated in the recent past by the Government of India to strengthen the general bankruptcy framework in India. The Corporate Insolvency Law or Companies (Second Amendment) Act was approved in January 2003. Although the impact of corporate sector's insolvency in India has not manifested perceptibly in the financial sector's insolvency, the fact remains that the magnitude of non-performing loans of the financial system is alarming. The Working Group has considered the observations of the Mitra Committee, the Eradi Committee and the Asian Development Bank's work on Indian Insolvency procedures, which have had commented extensively on the inadequacy of the current general insolvency regime in India.

The Working Group recommends that a comprehensive review of the Indian general insolvency law needs to be undertaken by the competent authority. Due to the established linkages between the health of the real sector and the financial sector and the social concerns associated with the insolvency in corporate sector, the Working Group recognizes the fact that if the general insolvency law is strengthened, it would greatly strengthen the Indian financial system. This is important considering the fact that at present the Indian financial system is not governed by a separate financial insolvency regime.

Issue 2 - The need for a review of the existing legal framework related to insolvency procedures pertaining to various classes of Indian financial institutions.

As mentioned earlier, all expert committees on the subject generally acknowledged the need for a change in current Indian insolvency law. The legislative framework is archaic. Recently it has undergone some changes. But changes are not comprehensive enough to keep pace with the evolving situation and to resolve the problems of distressed firms in the modern economic context. The demand for more concrete reform arises from the perceived inefficiency of current bankruptcy procedures, the main limitations being the following: scant consideration for the objective of protecting the value of the firm; harsh punishment for debtors, addressing the problems of incentives to initiate the procedure in proper time; lack of provisions permitting the transfer of bankrupt firms as going concerns; complexity, excessive length and high costs of the proceedings. Most of these shortcomings are a consequence of the limited scope of current bankruptcy legislation, which is essentially intended as a means to wind up the enterprises and to expel them from the market. Consistent with that aim, the primary concerns of the bankruptcy process have largely been the punishment of the inefficient debtor and the protection of the interests of creditors. In this context, the interests of the debtor are not taken into account, while the creditors are merely participants in a compulsory proceeding, in which they play a marginal role. On top of this comes the paradox that at the end of the proceedings the creditors normally see only a very small percentage of their claims reimbursed.

Economic effects of the inadequacy of the current legislation

The above mentioned limits of current insolvency procedures have serious effects on the Indian economy: our productive structure, comprising a very large number of small firms, is particularly open to the risks arising from inefficient insolvency legislation. Small firms have high birth and death rate and are consequently fairly likely to be involved in insolvency proceedings. Another factor is the inefficiency of market for reallocating ownership of small firms, due to typical information problems. Moreover, an inadequate insolvency law has significant effects on financing costs, which are normally higher for small firms. The inadequacies in the Indian legislation generate high direct legal costs, excessively lengthy liquidation proceedings and huge losses to the creditors.

Past attempts in initiating insolvency reforms

These facts show that it is imperative to design new solutions for the special problems posed by insolvency. The inadequacy of current legislation has been discussed for many years, not only in the academic world (among scholars), but also in Government Committees appointed to draft reform proposals. Especially worthy of note is the proposals contained in the Advisory Group on Standards and Codes for Insolvency (Mitra Committee) and Eradi Committee. At an international level, the

Asian Development Bank has also reviewed the Indian Insolvency regime as part of its review of the insolvency regimes of various Asian economies.

Focus of the proposed reforms

It is important to recall that an incentive to establish new rules for insolvency is the need to increase the competitiveness of the Indian economic system in the global market place. All major European countries have in the recent past adopted or proposed new bankruptcy and insolvency laws. In these countries, one of the major aims of the new laws is to shift the focus of bankruptcy law away from an exclusive protection of creditors' interests and towards a balance between protecting creditors and saving distressed firms. Consistent with this objective, the most recent reforms seem to reflect an underlying "pro-debtor" approach, in the sense that their effects on debtors are less harsh, in order to encourage them to initiate the proceedings in good time (i.e. before their financial difficulties become too severe), thereby improving the prospects of rehabilitating the enterprise. Some international bodies have also pointed out, in their economic analyses, the importance of adopting efficient insolvency procedures. An orderly and effective procedure, according to the IMF, addresses the inter-creditor problem by setting in motion a collective proceeding that seeks to achieve equitable treatment among creditors and to maximize the assets to be distributed to them. The primary objective of maximizing the value of enterprises, promoting amicable settlements and always encouraging adoption of the best solution to achieve that objective. In general the earlier, firms enter bankruptcy, the less financially distressed they are. From an efficiency standpoint, early initiation of bankruptcy procedure for distressed firms is therefore desirable, both because it minimizes creditors' losses if the firm is liquidated and because it maximizes the likelihood of saving the firm if an attempt is made to reorganize it. Early filing for bankruptcy can be encouraged by mitigating the punitive effects of initiation of the procedure and by leaving the debtor in control of the business.

As stated earlier, in the Indian context various committees have already suggested strongly that the existing legal framework needs to be strengthened to make the insolvency process speedier, more efficient and equitable. The working Group agrees unequivocally that legal uncertainty, inefficiency and potential inequity resulting from the existing legal and institutional underpinnings of insolvency may be incompatible with important objectives of public policy related to financial stability.

The Working Group felt that it is desirable to examine the current insolvency law with regard to commercial banks and financial institutions to evaluate legal rules governing insolvency by three criteria: efficiency of the insolvency process, equity of treatment and reduction of uncertainty. The Working Group is also of the view that while undertaking the insolvency reform exercise for the financial system it is necessary to ensure that the insolvency assets value is maximized. Reductions in legal uncertainty generally represent an improvement for debtors, creditors and other stakeholders. Nonetheless, the benefits from increased legal certainty need to be weighed against any negative impact on efficiency or equity associated with the rules used to enhance legal certainty.

The Working Group, therefore, recommends that it is desirable to examine the current insolvency law with regard to commercial banks and other types of financial institutions to evaluate legal rules governing insolvency by three criteria: 'efficiency' of the insolvency process, 'equity' of treatment and 'reduction of uncertainty'. The Working Group also recommends that while undertaking the insolvency exercise for the financial system it is necessary to ensure that the 'insolvency asset value' is maximized. Priority should be bestowed to the interests of the 'system as a whole' vis a vis the interests of 'individual entities' during the process of insolvency resolution.

In this context, the Working Group also recommends that sophisticated Early Warning Systems (EWS) for all categories of banks may be evolved as a tool for pre-insolvency intervention. Early Warning Systems will enable the regulators to intervene timely and initiate corrective measures to minimize the chances of a distressed bank sliding towards insolvency. More work needs to undertaken on this direction. **The Working Group further recommends that with a view to maximizing the depositors' and other creditors' welfare in failing banks it is desirable to have legal backing for the prompt corrective action (PCA) regime which has been introduced recently for commercial banks.** The legal enactment should provide for rule bound PCA regime with right balance of discretion. A framework of supervisory action for UCBs has already been introduced. The PCA must be developed for Regional Rural Banks and Local Area Banks also with an adequate legal backing.

Issue 3 – Need for a clear rule framework for specifying "priority among various classes of creditors" in the insolvency procedure.

One issue of critical importance in the exercise of initiating insolvency reforms is to lay down a specific set of rules for following "priority rules" to distribute the insolvency estate. In the event of an institution becoming insolvent the legal framework in place should unambiguously stipulate the relative priority among the various classes of creditors for deciding the distribution pattern after liquidating the insolvency estate. Such clarity is required for all the classes of financial institutions.

In the case of commercial banks the priority rules are laid down in Section 43A of the B.R Act. In terms of these rules depositors rank second after the priority payments as per Section 530 of the Companies Act 1956. The priority to depositors is limited to a meager amount of Rs.250/-. These priorities are inadequate from depositors' perspective. Since in the balance sheet of banks deposits are overwhelmingly the single largest liabilities, it may be desirable to provide greater priority to the depositors for sustaining confidence in the banking system. Additionally greater priority to depositors lowers the price of the deposit insurance also.

In the Indian context, the rules of "priority" are not clearly laid down in the case of cooperative banks also. As per the extant legal provisions, the amounts realized by the liquidator (net of expenses incurred by the liquidator) are required to be distributed amongst the depositors and the Deposit Insurance and Credit Guarantee Corporation (DICGC). However, the liquidators of Urban Cooperative Banks (UCBs) and co-operative banks have not been able to make any realizations and as a result, the claims of the depositors and DICGC (where the Corporation has refunded the depositors up to the insurance cover) could not be met. The law is unclear on the priority in which the realization should be distributed amongst the DICGC and the depositors. The law on insolvency should clearly indicate the priority in which the realization made by the liquidated / insolvent bank should be distributed.

The provisions for reimbursing the DICGC in terms of Section 21 read with General Regulations 22 of the DICGC Act are vague and open to several interpretations.

In this context, it may be stated that in the USA the National Depositors' Preference (NDP) Amendment of 1993 standardized the asset distribution plan for all bank receiverships and gave priority to depositors including the FDIC as subrogee for insured deposits. Under the NDP Amendment and related statutes claims are paid in the following order of priority.

(1) Administrative expenses of the Receiver
(2) Deposits (the FDIC claim takes the position of the insured deposits).
(3) Other general or senior liability of the institution (This includes all tax claims and foreign deposits)
(4) Subordinated obligation, and
(5) Shareholder claims

Prior to this amendment, insured deposits had a higher priority than uninsured deposits and other general creditors under the Banking Act of 1933. The Banking Act of 1935 gave the same priority to all the depositors and general creditors under the Banking Act of 1933. The motivation for the subsequent NDP Amendment elevating the claims of domestic depositors over the claim of foreign depositors and general creditors was the fact that this would result in substantial cost savings to the FDIC when it resolved failed institutions. There is, however, a debate in the USA as to whether this provision will serve its purpose because many large banks with international presence have substantial foreign deposits and unsecured liabilities and these liability holders in the event of distress, would seek to protect themselves by withdrawing funds generating liquidity crunch or seek securities. It is also possible that if foreign countries perceive the priorities as unfair, they may seize the assets of foreign branches of the failed U.S. banks, complicating the resolution of a large bank with substantial presence abroad. One of the possible solutions could be to consider foreign deposits as 'deposits' for preference purposes while remaining uninsured. Empirically the cost saving to FDIC from NDP Amendment or the apprehension of shifting behaviour for protection by foreign depositors and unsecured creditors has not been tested as there have been no large bank failures since then.

In the Indian context, the deposits held abroad are not insured but the status of these deposits in terms of priority is unclear in the B.R Act. Since, the structure of balance sheets of even the large Indian banks is very different from that of the large US banks, the apprehensions in USA that priority to domestic depositors may not reduce the cost to FDIC etc. may not be valid in India. Therefore, giving first priority to domestic deposits (including to DICGC to the extent of insured deposits payout) to foster confidence in the system by maximizing the welfare of depositors of failed banks is a very significant issue in India. Equally important is the fact that this proposition has the implication to reduce the cost of deposit insurance (premium). Considering the fact that premium is bound to go up from the present level on account of weaknesses and continuous failures in the co-operative sector, a lower premia structure on account of priority to deposits than what would be the case otherwise would be a desirable proposition given the suspect ability of many weak and not so strong co-operative banks in the system to pay high premium. There is, thus, a need to examine this issue afresh keeping in view the structure of balance sheets of Indian banks for devising a priority structure with complete clarity.

In the context of Urban Cooperative Banks (UCBs) it is suggested that in order to enhance the efficiency of the insolvency regime, the common law proposed for dealing with insolvency of banking entities could provide for special provisions for enforcement of security interest or we should consider whether the existing Securitisation Act, would suffice. The common law on insolvency should clearly indicate the priority in which the realization made by the liquidated bank should be distributed. The Working Group recommends to consider some mechanism through suitable provisions in the model Act, whereby a UCB which is insolvent (but yet to be liquidated) is precluded from alienating its assets.

Keeping in view various issues in this regard, the Working Group recommends that a well-defined set of rules for following "priority in distribution" may be framed under the insolvency resolution mechanism. The legal framework in place should explicitly specify the relative priority among the various classes of creditors in case of all the classes of financial institutions. The Working Group recommends the following order keeping in view the rationale specified earlier. All the secured creditors need to be kept out of the insolvency estate. After the costs related to the administration of insolvency process, the immediate priority should be conferred on domestic depositors. Next priority should be bestowed on all dues to employees followed by dues to Government and finally to the unsecured creditors. Depositors should have a floating charge on unencumbered assets of the insolvency estate. The secured creditors' unfulfilled claims, if any, are to be treated at par with the unsecured creditors' claims and may be bestowed the ultimate priority.

The Working Group also recommends that the liquidator should be empowered to realize the insolvency estate at the shortest time period possible. Legal framework needs to ensure this by removing the constraints to faster liquidation. In this regard the Group recommends that preference should be given to selling the assets even at a discount at the net present value (NPV) than preserving the assets for disposal at a later date. The official liquidator may be provided with adequate staff to facilitate faster realization of insolvency estate. These measures should facilitate expeditious resolution of the insolvency procedure.

Issue 4 - Need for a 'distinct bank insolvency law' in the Indian context

The issue as to whether banks require a special insolvency law as clearly distinguished form the general insolvency law needs careful consideration. The Working Group has considered the two existing models that are followed by various countries. While some countries treat banks like any other entity as far as the insolvency procedures are concerned, some other countries have a 'distinct bank insolvency law' in place. In India the general insolvency framework governs the banks and other financial institutions also. The Working Group has noted that the Mitra Committee was of the opinion that there is no need for a distinct law for banks and financial institutions and they can be treated like other entities.

The Working Group has carefully considered this issue, which is being increasingly deliberated in the context of insolvency reforms. The question as to whether the banks need to be accorded special treatment in insolvency need to be viewed from the perspective of the special role banks play in a country's economy. In order to justify this special attention to banks, reference is commonly made to certain exclusive functions of banks. Banks hold highly liquid liabilities in the form of deposits that are repayable at par on demand. They generally hold long-term loans that may be difficult to sell or borrow against on short notice. A bank's required capitalization covers the risk of loan loss and a cushion of liquid assets ensures its ability to cover withdrawals in normal times. If, however, something happens to disturb public confidence in the bank's ability to meet its payment obligations, massive withdrawals of deposits risk causing liquidity problems and may threaten the bank's solvency. What makes banks most special is their vulnerability to the loss of public confidence[1]. Recent crises in financial systems worldwide have

[1] Eva Hupkes, Swiss Federal Banking Commission.

demonstrated the close linkages between financial stability and the health of the real economy.

Therefore, it is necessary to consider financial stability as a public policy objective, warranting the attention of the authorities. The public policy goal is clearly served by lowering the probability of bank failures or addressing the issue of bank insolvency expeditiously. However, the irony is that the legal frameworks in many countries lack clarity regarding procedures for dealing with distressed banks. As a result, such procedures are often determined on an *ad hoc* basis. The reason for these lacunae earlier is the rarity of bank insolvency in the past due to massive involvement by the Government both as owner of banks and provider of emergency "bail-out" funds in various countries. Therefore, in many jurisdictions general insolvency law is unless otherwise stated, deemed also applicable to banks. This is still the case in many jurisdictions including India.

One critical question in this regard, which requires clarity is whether general insolvency law is effective and actually works for banks also? To take an unbiased stand on the issue, the Working Group considered the question as to why we should not apply general insolvency rules only to banks also? In fact, numerous aspects of bank liquidation, such as the calculation of the assets, the verification of claims, the adjudication of disputed claims and the distribution of assets will need to be handled largely in the same manner as the liquidation of a commercial company. Certain special provisions are already existing in the B.R.Act in respect of bank insolvency. In most European countries the insolvency law applies to banks, while special rules or exemptions from the general regime apply where called for by the specifics of bank insolvency. For instance, in Italy, the banking law sets forth several special rules for bank insolvency, while the provisions of the Italian bankruptcy law continue to apply with respect to matters not expressly provided for in the banking law. Norwegian law sets out a special public administration regime for banks and provides that the general insolvency rules contained in the "Act on Debt Settlement Proceedings and Bankruptcy" apply in case of a winding up and liquidation, where appropriate. The UK law treats banks in the same way as any other type of company and does not provide specific provisions for the reorganization or liquidation of financially distressed banks. Contrary to the majority of European legislators that chose to apply ordinary insolvency rules to banks, the United States Congress opted very early for a special bank insolvency regime. Under the National Bank Act of 1864, it was the Comptroller of the Currency, rather than the judiciary, who was empowered to appoint a receiver for national banks. Alongside federal regulation, most American states established their own statutory regimes for supervising banks and resolving bank insolvency. The Bankruptcy Act of 1898 explicitly excluded banks from its coverage and continues to do so. At its creation, in 1933, the Federal Deposit Insurance Corporation (FDIC) became the exclusive receiver for failed national banks, as well as the receiver for state chartered banks at the discretion of state authorities.

The most important argument in favour of having a special bank insolvency law is in the interest of preserving financial stability, banks warrant special treatment. The extent to which such rules are needed depends on the legal infrastructure in each country, in particular the interplay between banking and insolvency law and the flexibility of the judicial system. The other related question, which also needs clarity, is should those special rules apply only to banks? The contemporary reality is that financial problems and systemic risk can also originate in financial markets and such markets are constituted not only by banks but also by a large number of non-bank financial institutions and conglomerates, which combine banking, insurance and securities activities. This raises the debate of whether those institutions also deserve special treatment in insolvency in the same way as banks. The ongoing consolidation between banks and financial institutions is likely to result in a relatively limited number of huge financial institutions worldwide. Many of them will remain engaged in banking only, but a growing number will combine the different sectors of financial services. At the same time, it can be expected that the number of banks that can be characterized as medium-sized will continue to shrink, while, smaller commercial or retail banks with local or regional presence, as well as specialized niche providers will continue to exist. Furthermore, there are now non-financial companies that undertake financial activities on a scale that approaches those of major financial institutions. These developments will further complicate the work of bank supervisors and regulators. While there will continue to be a need for bank insolvency rules to address the failures of smaller local banks, there will also be a growing number of mega banks or conglomerates and specific rules will need to be devised for the proper handling, both preventive and corrective, of those institutions. Such rules will have to provide for effective coordination and cooperation not only between supervisors within one country but also the various national supervisors.

While advocating a distinct bank insolvency law, it is necessary to be clear about certain issues in the context of a debate on a separate bank insolvency regime. Questions like who should be in charge of the resolution of bank failures: the banking supervisor or as under general insolvency law, the courts or should there be some form of division of labor between them? etc. need clear answers. Some argue that bank supervisors should deal only with currently functioning banks, while those are sick or potentially dead banks should be buried. Banks are already subject to special regulation, which determines the conditions of their operation. It is, consequently, only the bank supervisor and not a bankruptcy judge or a meeting of creditors who is in a position to determine whether a bank is viable. Thus, the bank supervisor must have a voice in the insolvency procedure. Should the bank supervisor be in charge of the entire insolvency procedure? Or, should the procedure be turned over to a bankruptcy court? If so, at what stage in the process? All these questions need clear answers. While insolvency regimes differ widely from country to country with respect to the extent to which they rely on special procedures for resolving bank failures, there is a marked trend toward providing the supervisor with wider powers and to either complement or replace powers previously exercised by judicial authorities.

The working Group recognizes the transformation that is taking place in the ownership pattern of the Indian banking system and the special and exclusive role played by the banks and the financial institutions in the economy. Keeping in view the Indian experience and the experience of others with regard to insolvency of banks, the Working Group recognizes the increasing need for a special financial insolvency law to the Indian financial system and, therefore, recommends that there is a need to evolve a distinct and special financial insolvency law in India, which is efficient, expeditious and equitable that covers all types of financial institutions.

Issues in respect of co-operative banks:

(i) The provisions applicable for acquisition of undertakings of banking companies or winding up of banking companies as enunciated in Part II C and Part III of the Banking Regulation Act, 1949 are not applicable to co-operative banks [including urban co-operative banks (UCBs)]. Only the provisions of Section 45 (1), (2) and (3) of the Act which deals with RBI making an application to the Central Government for issue of an order of moratorium and the Central Government acting on that order, are applicable to co-operative banks. The amalgamation / reconstruction / liquidation of a co-operative bank is therefore, governed by the provisions of the State Acts. As per the State Acts, the grounds on which a co-operative bank can be taken to liquidation by the State

Government [the Registrar of Co-operative Societies (RCS)], among others, are the following:

(a) after making an inquiry,
(b) on receipt of an application with a resolution carried by $3/4^{th}$ of the members of the Society present at a Special General Body Meeting called for the purpose.

(ii) The provisions of the Acts of the various States in regard to the liquidation of co-operative banks are generally uniform in nature. The State Acts also provide that the order for winding up or an order sanctioning a scheme of compromise or arrangement or of amalgamation, or reconstruction of a co-operative bank can be made only with the previous sanction, in writing of the RBI. Besides, Section 13D of the DICGC Act, 1961 list outs the circumstances under which the RBI may require the winding up of a co-operative bank.

(iii) Some of the State Governments and also the Central Government, have enacted new Co-operative Societies Acts under the National Co-operative Policy providing for more autonomy to the co-operative banks. These enactments do not, however, conform to the DICGC Act, 1961 and as a result, the co-operative banks (including the multi-state UCBs) registered under these Acts are not "eligible co-operative banks" for the purpose of deposit insurance cover of the DICGC. Amendments proposed to the B.R.Act are expected to resolve this.

Considering these facts, the Working Group recommends that the UCBs are primarily banking entities and a uniform and separate insolvency law exclusively dealing with various categories of banking companies, including co-operative banks, as suggested above would be a desirable goal.

Non-bank finance companies

With regard to non-bank finance companies presently the procedure under Section 391 of the Companies Act for restructuring of the liabilities is not only time consuming, the procedure itself is unduly long. The Working Group is of the view that a special insolvency law on the lines of what has been suggested for commercial banks related insolvency might be conceived for the NBFCs also.

Issue 5 - Introduction of "speedy and market-based insolvency mechanisms" in India.

The Contact Group's Report describes and recommends the implementation of certain 'speedy and market-based insolvency mechanisms'. Perhaps, the most important source of uncertainty and inefficiency lies in the slowness of traditional insolvency processes. Insolvency process tends to be initiated later than they should be and to be very slow after their initiation. Late initiation is a problem of incentives. Creditor incentives are strong and creditor initiation is, therefore, made difficult in insolvency regimes. Debtor initiation is easy but debtors seldom have incentives to declare early insolvency. Regulatory incentives are blunted, unless the regulator has a direct financial stake, e.g. as an insurer.

The Working Group has considered the issue of the need to expedite the liquidation process and the desirability of implementing speedy and market based insolvency mechanisms. The insolvency process in India is extremely tardy with liquidation proceedings taking several years or even decades. Such tardy process fails to maximize the asset values of failed banks thus generating large credit risk as also tremendous liquidity risk for the depositors and other creditors. Such a state of affairs is not conducive to generating confidence in the banking system.

Commercial Banks

At present, there are 78 banks under liquidation all over India. The liquidation proceedings have been prolonged for several decades, which would be evident from the fact that out of 78 banks, liquidation proceedings in respect of 76 banks are pending for more than 30 years. Reserve Bank of India makes an application for winding up of the banking company under Section 38 of Banking Regulation Act, 1949 and on the High Court passing orders of winding up, the banking company is put under liquidation. For this purpose, the High Court appoints a court liquidator in terms of Section 38 A of the Act who undertakes realization of the assets of the banking company to pay all its liabilities till final dissolution.

The matter regarding expeditious completion of liquidation proceedings has been under correspondence with Government of India since a long time and in January 1991 Government of India, Ministry of

Finance, advised Reserve Bank of India that the Department of Companies Affairs (DCA) have advised the liquidators, specially in Mumbai and Calcutta to bestow their personal attention to the cases of liquidation pending since 20 to 30 years and to undertake review of the progress made periodically. They were also advised to send quarterly progress reports to the DCA in this regard. One of the major constraints put forth by the Liquidators related to the shortage of staff attached to his office to look after the work of liquidation of banking companies.

It will, thus, be seen that Reserve Bank of India by itself cannot expedite matters or take steps in removing the difficulties faced by the official liquidators as they are under the control of Central Government and it is for the Government/Courts to take appropriate decision in making the role of liquidators more effective. Reserve Bank of India has been pursing this matter with Government of India. During the last 10 years, except for one bank viz. Bank of Karad Ltd., no other bank has been put to liquidation. The existing problem relates to banks liquidated prior to 1960. Currently restructuring is mainly by way of amalgamation.

Non bank financial institutions

With reference to non bank financial institutions, a proposal was mooted by Department of Non-banking Supervision to the Government that speedy winding up of the NBFCs on the lines of provisions of Section 38 of the B.R Act should be included in the Financial Companies Regulation Bill (FCRB). This is in view of the presently innate time consuming winding up operations under the Companies Act which is jeopardizing the interests of the depositors in early recovery of their money from the defaulting NBFCs. However, Government of India did not favour the proposal in view of the recommendations of the Eradi Commission to set up National Company Law Tribunal (NCLT). Accordingly, a provision has been made in the FCRB that the provisions of the Companies Act would be applicable to the winding up of the NBFCs. The Working Group learnt that the Companies Act has since been amended to clear the setting up of the NCLT. However, as NBFCs are playing a significant role as financial intermediaries, a separate speedy winding up process of the NBFCs on the provisions of Section 38 of the B.R.Act is needed in the opinion of the Working Group.

Urban co-operative banks (UCBs)

The insolvency proceedings of UCBs take unduly long time. The delay is partly on account of the State Governments not appointing the liquidators expeditiously, absence of qualified personnel, etc. Further, one Co-operative Department official is often assigned as official liquidator of more than one bank. This delay in the insolvency proceedings results in the depositors not getting their claims settled expeditiously. However, market based solutions of insolvency have already been resorted to, though in a limited scale, while undertaking mergers / amalgamation of UCBs. Some of the methods adopted are:

(i) Purchase and assumption (P&A) transaction where a strong bank takes over some or all assets and liabilities of the failed institution with the shortfall in assets (for payment to the depositors) being met by the DICGC. However, there is no established legal framework, which would facilitate P&A transactions.

(ii) Reconstruction schemes (which are formulated by the members and notified by the competent authority after RBI gives its prior approval), envisage a viable entity being reconstructed with the DICGC meeting the shortfall in assets to refund the deposits up to the amount of insurance cover.

While considering the above issues, the Working Group believes that there is a need to thoroughly revisit the existing relevant laws and revamp them with a view to speed up the liquidation process by the competent authority. The Working Group is of the view that so far the restructuring process of commercial banks in India has been mainly by way of amalgamation and hence the problem of widespread liquidation of banks did not occur. However, with the rapid increase in the number of private sector banks the situation would radically change. Against this setting, the Working Group favours evolution of a speedy winding up process for all categories of financial institutions. The Working Group favours a speedy winding up process for the NBFCs on the lines of the relevant provisions contained in the B.R Act.

With reference to UCBs a facilitating legal environment could be provided in the insolvency reforms with reference to Purchase and Assumption (P&A) transactions. The insolvency proceedings of UCBs need to be made more efficient by entrusting the work relating to insolvency of banks / UCBs to a separate institutional mechanism, like the proposed BDIC, as in some of the countries like the US. Once the BDIC is asked to initiate the insolvency proceedings of a bank, its decision should be given finality. There is a need to provide certain parameters for evolving reconstruction schemes for UCBs. The reforms could consider providing a legislative framework dealing with the minimum parameters to be complied with for approving reconstruction schemes. In order to ensure efficiency of the insolvency process, it would be desirable to provide for these aspects in the model law. It would be desirable to link exposures of small urban co-operative banks with DTL below a cut-off limit to their DTL as was the case earlier instead of capital funds as at present.

Issue 6 – Payment system related issues

(a). Securing the Collateral

Members of a payment system repose confidence in it due to the fact that every member has offered collateral against their own exposures to the rest of the members of the system. In the face of insolvency, if this collateral is not available to the rest of the members, the confidence that the members have in a payment system will be undermined. Therefore, it is imperative that there is no ambiguity with regard to the collateral being available to the other members. Any ambiguity in this regard will lead to compromising legal certainty, one of the three principles besides efficiency and equity, the BIS Report enshrines, and can potentially trigger systemic crisis in the face of insolvency of a member.

The Group, therefore, recommends that in the face of insolvency, the first claim on collateral given by a payment system participant, (even though not extended to a specific participant, but to the system as a composite whole), is available to other payment system participants.

(b). Settlement Obligation

Multilateral netting of settlement has been the most preferred option in most of the payment systems. Under the current Insolvency laws, the legal position relating to this is not clear. There is a general notion that the Indian laws do not/will not recognize multilateral netting. This has the tendency to undermine the confidence that the participants have in Payment Systems and can add systemic risks in case insolvency occurs. International best practices outlined in the 'Core Principles for Payment Systems' prescribe that the multilateral netting of settlement should not be disturbed by general insolvency laws and procedures.

Therefore, the Group recommends that multilateral net settlement obligations should prevail even in the face of insolvency. The Group notes with satisfaction that this aspect has already been

taken care of in the draft Payment and Settlement Bill prepared by the RBI's Committee on the Payment Systems.

(c). Close-out Netting

In the payment systems, especially the ones related to the derivatives, transactions could be of two types: (i). participants' own proprietary positions; and (ii). customer related positions. The customer related positions could be shifted to another live party without much difficulty in the face of insolvency of a member. The method of dealing with the proprietary positions of the insolvent member needs to be addressed. Keeping the principle of maximizing the value of the insolvency estate as the prime objective, the earliest resolution of the assets through market mechanism would offer the best possible value. Close-out netting is one such market mechanism that aims at achieving this objective. Leaving the positions open to be handled by the liquidator entails further risk of loss of market value as generally liquidators may not be market savvy and reaction time of the liquidators will not be faster in comparison to market mechanism such as close-out netting.

Therefore, the Group recommends that closeout netting should be applied to outstanding positions of the insolvent party as soon as the insolvency has been declared.

Issue 7 – Need for initiating cross-border insolvency reforms.

The impact of insolvency has been felt at an international level with a number of instances occurring over the centuries illustrating the complexities of those trading and commercial links, which have long been important for the lifeblood of nations. The rise of international commerce and the relative ease of incorporations in more than one jurisdictions have meant that many companies have had little difficulty in expanding corporate empires in line with growth in the world economy. With expansion came considerations of choice of law in international contracts and conflicts of law in litigation. With cyclical downturns in national economies and on a global scale, inevitably considerations have turned to creating rules in relation to insolvency with an international dimension. Nevertheless, there are a number of problems in international insolvency, which raise a number of important issues. When a large financial firm becomes insolvent, it can cause widespread disruption and could trigger a systemic crisis. How international insolvency should be managed is important to those who are directly involved in such cases such as lawyers and judges, but its systemic risk implications make it a central concern for economic policy makers and regulators. In the international context, financial contracts, which are basic building blocks of economic transactions are becoming increasingly complex and difficult to interpret.

United Nations' Commission on International Trade Law (UNCITRAL) Model Law

UNCITRAL was created by the United Nations in 1966 'to further the progressive harmonization and unification of the law of international trade'. In April 2001, the World Bank published a paper, 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems', which noted that insolvency proceedings may have international aspects, and insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, cooperation among courts in different countries and choice of law. The World Bank paper further stated that the most effective and expeditious way to achieve these objectives was to enact the UNCITRAL Model Law on Cross Border Insolvency. The International Monetary Fund also expressly supported the enactment of the Model Law. In its 1999 Report on Orderly and Effective Insolvency Procedures it concluded that, in light of the growing importance of cross-border insolvency, measures should be introduced to facilitate the recognition of foreign proceedings and cooperation and coordination among courts and administrators of different countries. The enactment by countries of the Model Law prepared by UNCITRAL would provide an effective means of achieving these objectives. The UNCITRAL Model Law has also received almost universal endorsement from leading practitioners and academics around the world.

Cross-border insolvency framework in the Indian context

Indian law would not recognize foreign insolvency procedures over an Indian Company. An insolvency order in order to be recognized against an Indian company has to be passed by the Company Court and no foreign court has authority to declare an Indian company as being wound up. A foreign court can at best pass a judgment against assets within its jurisdiction. If the judgment is unsatisfied, based upon rules of reciprocity and recognition of foreign judgments either the foreign judgment or decree may be executed in relation to reciprocating territories or found a new cause of action based upon the judgment in India. When a judgment is rendered as a judgment debt and is unsatisfied, insolvency procedure can commence in India before the Company Court. As explained above, no foreign court has authority as a Company Court to render a judgment or order of winding up in a foreign jurisdiction with reference to Indian companies. Therefore, the question of a foreign insolvency judgment of an Indian Company being recognized in India does not arise.

The issues of corporate groups are especially important for large, internationally active financial institutions. The concept of 'comprehensive consolidated supervision' (CCS) of unified bank supervision demands a central supervisor responsible for entire financial group, no matter where the group entities are incorporated. Local supervision and entity-based supervision are not inconsistent with this concept but the central supervisor is responsible for the entire organization. Local supervisors are discouraged from permitting entry of financial firms that do not enjoy CCS. The CCS concept is extremely powerful, because it is a jurisdictional and organizational focal point that could facilitate universal insolvency proceedings applicable to corporate groups. CCS is not susceptible to forum shopping, because it is indisputable ex ante and (relatively) immutable ex post. It permits an organic connection between supervision and insolvency on an international scale, accommodating the business overlap across entity and jurisdictional lines. CCS is not yet an element of financial insolvency law. In some jurisdictions, the host country's supervisor has statutory responsibility to protect local depositors in the event of a foreign bank failure.

It is worth noting that banks generally operate through branches, unlike most other international firms, which operate through local subsidiaries. The problem of corporate groups therefore does not apply to most international banks, viewed as standalone entities. (The separate entity doctrine, however, may require separate proceedings for individual branches.) However, as discussed above, larger banks commonly belong to a group and engage in substantial transactions with their non-bank affiliates, so the problems of corporate groups are applicable to banking organizations, even disregarding the separate entity doctrine.

Financial and non-financial institutions are both affected by this problem. Banks rely on netting and collateralization in their risk management, which is frequently cross-border in nature. Non-financial organizations frequently employ cross affiliate guarantees, which have a cross border component.

Need to consider model law as the basis for review of Indian cross-border insolvency regimes?

Is India's current legislation considered adequate at present to deal with cross-border insolvency is a sensitive but crucial question. Going by the observations made by the Advisory Group on Bankruptcy Laws, the existing legal framework in respect of insolvency is grossly inadequate. In this context, there appears to be a case for India to seriously consider adopting the UNCITRAL Model Law. A model law is a legislative text that is recommended to various countries for incorporation into their national law. Therefore, in order to achieve a satisfactory degree of harmonization and certainty, it is recommended that the countries make as few changes as possible in incorporating the model law into their legal systems. There are many economic factors favouring adoption of the Model Law. First, there is a need to address cross-border insolvency problems arising from the perpetration of fraud by electronic means. Second, fair treatment of foreign creditors is likely to influence foreign investment favourably. Third, there is likelihood that the Model Law will be widely adopted as part of IMF relief packages to states in financial distress. Fourth, fair treatment of foreign creditors by our courts is likely to lead the courts of other countries with which we trade to adopt a similar approach to our creditors who are in competition with their domestic creditors. It is necessary for the law governing international trade to reflect global trade developments.

As present the current domestic law is considered inadequate in dealing with corporate insolvency, adoption of the Model Law would prove a satisfactory option. It would align Indian legal practices with other trading nations' practices, which adopt the Model Law. In the light of the recommendations of the Mitra Committee, India has to consider adopting the UNCITRAL Model Law on cross-Border Insolvency to equip the Indian law with sufficient provisions to deal with international insolvency. This model law, if adopted, will radically change the orientation of Indian law and make it suitable for dealing with the challenges arising from globalization and increasing integration of Indian economy with the world economy. The Indian law, as it exists today, provides only for the recognition of foreign judgments. Neither the Civil Procedure Code nor any other law deals with the recognition of foreign proceedings.

The UNCITRAL Model law caters to this deficiency and therefore the Working Group endorses the recommendation of the Mitra Committee and the Eradi Committee in this regard that India

should consider adopting the UNICITRAL model law on cross border insolvency. The Working Group recommends that in the context of cross border insolvency, while the move towards adopting UNCITRAL is a move in the right direction, it is also desirable to implement the concept of comprehensive consolidated supervision (CCS) and also to put in place a formal or informal protocol of supervisory exchange with other supervisors both domestic and foreign based on mutual cooperation.

The Working Group strongly favours that in the context of cross border insolvency forging cooperation with other countries is a desirable approach. As regards CCS and protocol for exchange of supervisory information with other supervisors it may be stated that both are requirements under the "Core Principles for Effective Banking Supervision". While prudential regulations for consolidated supervision have been introduced very recently, the next step of having a CCS responsible for the affairs of the entire group should be taken in due course to enhance the quality of supervision as also to be in greater alignment with international norms.

Issue 8 – Adequacy of exposure norms

The Contact Group Report discusses the issue of the need to put in place appropriate exposure limits by financial firms and markets, which are often found to have large exposures to non-financial firms, as both creditors and counterparties. The Working Group considered this issue in the Indian context by carefully examining the extant norms. **In view of the wide coverage as also the flexible approach adopted, the exposure norms currently prescribed for commercial banks are considered to be adequate to address issues such as concentration of risk and credit risk management. In view of the above the Working Group is of the opinion that no changes are required at this stage to the extant 'exposure norms' stipulated for banks. However, a periodic review and monitoring of the extant exposure norms is recommended.**

Exposure norms as applicable to commercial banks have been extended to UCBs. Earlier, the UCBs were subjected to a maximum limit on advances based on the level of DTL. With the introduction of exposure norms based on the capital funds, a situation has emerged whereby a small co-operative bank is able to built up exposures disproportionate to its capital funds. **In this connection, the Working**

Group recommends that the exposure norms applicable to small UCBs could be related to their DTL as against the existing norm of linking to the capital funds.

In the case of non-banking financial companies, in terms of prudential norms, exposure ceilings have been prescribed for single party and single group of parties for credit and investments with relation to the owned funds of the NBFC. Such exposure also includes non-fund based facilities granted, if any, to a borrower. The mergers and acquisition of NBFCs would strengthen their capital base and thus enhance their ability to lend to a single borrower or a group of borrowers. It is expected that the NBFCs build up loan appraisal capabilities to assess the credit proposals from large borrowers and safeguard their interests. The increased capital base would no doubt add to their resilience to absorb shocks of loan losses or adverse business cycles. As such, the Working Group feels that developments like mergers and acquisitions of the financial intermediaries would not call for a review of the present exposure ceilings with regard to the NBFCs.

Issue 9 – Issues related to propagating securitisation

In the light of the discussion on financial arrangements like 'securitisation' and 'outsourcing' in the Contact Group's Report, the Working Group reviewed the issue as to what are the current impediments to propagate financial arrangements like 'securitisation' in India? The Group has taken note of the enactment of the Act "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002" for this purpose in India.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, was enacted by the Government on June 21, 2002. The Reserve Bank has issued on April 23, 2003 the final guidelines to securitisation and reconstruction companies (SC/RC) to facilitate the smooth formation and functioning of these companies. It has also prescribed the form of application to be submitted by the SC/RC seeking registration from the Reserve Bank of India under Section 3 of the Act. The Act has been well taken by the banks and FIs, which is burdened with high level of NPAs and had no succour for recovery of dues otherwise than through legal measures which is time consuming. The Reserve Bank has received application from SC/RC for registration and the same is under scrutiny. As the companies are yet to start the activities of securitisation and asset

Reconstruction, the success or otherwise if any is yet be felt. **Therefore, the Working Group recommends that the current efforts to popularize securitisation are on right direction and should be persevered. NBFCs are not currently covered under the Act. The Working Group recommends that the NBFCs need to be covered under the relevant Act.**

UCBs

The State Acts vest powers with the liquidator to enter into any scheme of arrangement for the purpose of winding up the co-operative banks. The Acts also permit the liquidator to set off the claims of the creditors against the monies due to them. **Although the Securitization Act does not specifically provide for entering into securitisation arrangements by the liquidator, this itself does not appear to be prohibiting such arrangement. The Working Group proposes that the legal framework should explicitly provide for usage of these arrangements, so as to enhance the efficiency of the insolvency regime.**

Issue 10 – Role of the regulator in initiating the insolvency process

As per the current provisions, RBI has to play a dual role as the regulator of the financial system and at the same time, if it need be, the initiator of insolvency proceedings for the entities in the Indian financial system. The Working Group examined the issue as to whether there is any need to review this position in the light of recent developments like failures of the urban banks and co-operative banks. Since a deposit insurer has a larger stake in expediting the insolvency process and maximizing the bankruptcy estate, there could be an argument for entrusting the resolution of banks to the DICGC. This means that once a bank is to be resolved as per the laid down criteria (e.g. under a PCA regime) the bank passes on to the DICGC for resolution. This would require a higher level of expertise in the DICGC and would also have implications regarding sharing of supervisory and regulatory powers between the RBI and the DICGC. This may not be suitable in the Indian context, particularly because even RBI is hardly in a position to close down failing banks based only on prudential considerations. In the alternative, the DICGC may be considered to play a limited role in the resolution process i.e. that of a liquidator. The rationale would be that a professional agency with financial stake in the insolvency process would be more suited for the purpose. However, given the current provisions in the laws this is not practicable, as DICGC would get bogged down for several years with each liquidation proceeding. **The Working Group recommends that, as stated earlier, the relevant laws need to be modified to expedite the insolvency resolution process and contingent upon that it may be possible in the medium term to consider handling of liquidatorship by DICGC.**

B. GENERAL ISSUES

Issue 1 - Need for harmonization of insolvency regimes with sound practices elsewhere.

A keen debate is underway to conceptualize whether there is any need to forge uniformity of bankruptcy laws as a prerequisite for effective economic integration among various countries. As bankruptcy is an inevitable reality of modern business, the harmonization of its principles between comparable trading nations is increasingly considered a hallmark of the efficiency and sophistication of nations' capacities to engage in international commerce. Given the growing volume and extent of cross-border trade among various countries, the need is great for the legislative and judicial coordination of insolvency matters in the form of a standardized, transnational framework designed to minimize the resultant legal complexities and potential economic harm of commercial endeavors that encounter financial difficulty. It is considered that the present inconsistent and inefficient insolvency regimes are wasteful and often prohibitively expensive. While there have been suggestions that it is imperative to have harmonization of insolvency regimes on the grounds that such agreements are beneficial, the feasibility and desirability of such harmonization is questioned by many on valid grounds.

The Working Group has considered various arguments in favour of and against broad 'harmonization' of the insolvency framework. Viewed from a country's domestic and historic perspectives, it is highly unlikely that various countries will administer their bankruptcy regimes reciprocally or subject their bankrupt nationals to the other's insolvency laws given that states generally detest to cede their sovereignty. However, in the changing circumstances, since various countries have major corporate enterprises that are situated in several countries and cross-border insolvency remain unregulated, the primary location of a bankrupt does not automatically resolve conflict of law dilemmas. So the option of putting in place well-defined uniform insolvency proceedings provides the only solution that can reconcile the international legal dysfunction inherent in the coexistence of bankruptcy laws with the doctrine of jurisdictional sovereignty. In an increasingly integrating world when the legal frameworks are divergent and conflicting, the time, effort and costs involved in sorting out trade and commercial differences on a regular basis is also highly undesirable. So some compromise and abdication of exclusive jurisdiction for the settlement of economic disputes provides a beneficial precedent for undertaking a bilateral bankruptcy convention.

Similarly there are arguments against harmonization. It is well recognized that advocacy of a harmonized insolvency procedures among various countries is strained with fundamental inconsistencies. While the differences in the bankruptcy laws of the various countries indicate the need for a harmonized, bilateral regime, they also indicate that a common approach to law may prove ultimately unsuccessful due to the inbuilt inherent self-interests of various parties. The harmonization process invariably involves in some sacrifices and some amount of self-sacrifice. If in the process of harmonization, the interests of some domestic entities have to be lost or some well tested and trusted domestic laws need a modification and such a change is normally not acceptable as a ground reality.

This is not to belittle the need for upgrading the insolvency regimes. The antiquated insolvency regimes need to be changed and reforms are a *sine quo non* in the changed economic setting. On balance, what is desirable is some degree of standardization of insolvency resolution approaches rather than absolute harmonization of substantive bankruptcy laws. Some suggest a bi-lateral cross-border insolvency accord as an option for harmonization. In practice this may be less desirable in many ways due to the conceptual and procedural difficulties inherent in bankruptcy treaties. These issues are valid questions and the fundamental contradictions in the debate on harmonization, which will ensure that any renewed negotiations toward a cross-border accord among various countries will be a cautious, narrow, and inherently contestable if not ultimately imperfect endeavor.

All in all, a perfect harmonization is neither feasible nor desirable. The Working Group believes that there can never be a "one-size fits all" kind of insolvency system. An insolvency system will function well only if it accurately reflects the special characteristics of the country within which it operates. Insolvency systems will therefore embody different policy choices on procedural and substantive laws, including the allocation of risk among all participants and should take into account the strengths and limitations of the institutional infrastructure, level of economic development, social traditions, and legal structures. However, it is also recognized that all insolvency regimes must contain certain fundamental features. In other words, a country's special characteristics should not be emphasized to such an extent that the effectiveness of the insolvency system is sacrificed. The notion that there is no "one-size fits all" model should lie at the heart of the effort to design a set of principles and guidelines on building effective insolvency systems. In this regard it may be worthwhile to accept select guidelines suggested in certain multilateral institutions' reports that will assist countries to benchmark their insolvency systems, which can strengthen the insolvency framework. Notwithstanding the considerable flexibility in designing a well-functioning insolvency system, certain core features are essential to all insolvency regimes.

Considering various issues involved in the process of harmonization of domestic laws, the Working Group believes that the issue is not whether our domestic insolvency regime is harmonized with other countries' insolvency regime or not. A more meaningful consideration is whether our insolvency regime is conforming to the features that characterizes the regime as efficient, predictable, speedy and equitable so that it can address both domestic and international concerns. Viewed from this perspective, **while reiterating that the Working Group is not keen to have an absolute harmonization of the Indian insolvency regime with any other country, it recognizes the urgent need to review the insolvency regime to strengthen the same keeping in view the sound practices evolved over the years to make it responsive to the emerging milieu. In particular the Reports prepared by the multilateral institutions like the World Bank and IMF provide a basis for conceiving a set of sound practices.**

Issue 2 - Implications of increasing financial integration for existing regulatory/supervisory frameworks and for the insolvency regime.

The genesis of the Contact Group's Report may be traced to the threats posed by the financial integration and its impact on insolvency. Indian financial system has exhibited notable increase in the degree of interdependence and integration in the last decade or so as a result of financial sector reforms. The difference between banks, non-banks, development financial institutions, insurance and securities firms could get increasingly blurred over time with increasing trend towards universal banking and financial conglomeration, as has been the experience with matured financial systems. The degree of interaction between financial institutions and financial markets would also increase further as institutions emerge clearly as both market makers and market players, with large exposures in derivative instruments. With further financial deepening, greater volatility could also become a permanent feature of the financial markets, which would exert increasing pressures on the risk management abilities of the banks. With greater integration, risk transmission will be faster, and the probability of any individual bank crisis acquiring systemic character will also increase.

As noted by Kaufman (1996)[2], "Because banks are closely intertwined financially with each other through lending to and borrowing from each other, holding deposit balances with each other, and the payments clearing system, a failure of any one bank is believed to be more likely to spill over to other banks and to do so more quickly. Thus, the banking system is seen as more susceptible to systemic risk." In banking, contagion is perceived to: (1) occur faster; (2) spread more widely within the industry; (3) result in a larger number of failures; (4) result in larger losses to creditors (depositors); and (5) spread more beyond the banking industry to other sectors, affecting the macro economy of the country where the crisis starts as well as other countries. Systemic risk is perceived to occur because all economic agents are interconnected. Thus, banks are widely perceived to be particularly susceptible to systemic risk, and shocks at any one bank are viewed as likely to be quickly transmitted to other banks, which in turn can transmit the shock down the remaining chain of banks.

Growing integration, thus, could potentially increase the risk of systemic banking crisis (which India has successfully avoided so far) and also increase the incidence of insolvency and the associated costs (which is yet to become a major concern for India). While stronger supervision and regulation aims at prevention of crisis, insolvency procedures aim at resolving the after effects of the crisis. International experience suggests that stronger preventive measures have not foreclosed the scope for the emergence of crisis. The process of consolidation and conglomeration (where banking, securities, and insurance businesses merge) has given rise to situations where the number of banks has declined in almost every advanced country. Diversification of activities (cutting across banking, insurance and securities business) leads to risk reduction, but individual bank failure has potentially greater risk for the financial system.

Keeping these issues in mind, the Working Group feels that the low incidence of bank liquidation in India hitherto is partly explained

---

[2] Kaufman, George G.(1996) Bank Failure, Systemic Risk and Bank Regulation, Cato Journal, Vol. 16, No.1

by the public sector character of a large segment of the financial system hitherto. With gradual privatization and freer operation of private and foreign banks, the pressure of competition could increase the scope for mergers and acquisitions as well as liquidation of insolvent banks. Insolvency regime, therefore, is going to acquire greater importance, and the need for strengthening institutional reforms consistent with the requirements of a market driven financial system would demand that India must aim at putting in place an efficient and strong financial sector insolvency regime at the earliest.

SECTION - III

Summary of Recommendations

Impact of corporate sector distress on the financial system

The Working Group recommends that a comprehensive review of the Indian general insolvency law needs to be undertaken by the competent authority. Due to the established linkages between the health of the real sector and the financial sector and the social concerns associated with the insolvency in corporate sector, the Working Group recognizes the fact that if the general insolvency law is strengthened, it would greatly strengthen the Indian financial system. This is important considering the fact that at present insolvency in the financial system is not governed by a separate financial insolvency regime in India.

Criteria to be adopted to examine the current insolvency framework with regard to the financial sector

The Working Group recommends that it is desirable to examine the current insolvency law with regard to commercial banks and other types of financial institutions to evaluate legal rules governing insolvency by three criteria: 'efficiency' of the insolvency process, 'equity' of treatment and 'reduction of uncertainty'. The Working Group also recommends that while undertaking the insolvency exercise for the financial system it is necessary to ensure that the 'insolvency asset value' is maximized. Priority should be bestowed to the interests of the 'system as a whole' vis a vis the interests of 'individual entities' during the process of insolvency resolution.

Need for developing sophisticated Early Warning Systems

In this context, the Working Group also recommends that sophisticated Early Warning Systems (EWS) for all categories of banks may be evolved as a tool for pre-insolvency intervention. This measure would enable the regulators to intervene timely and initiate corrective measures to minimize the chances of a distressed bank sliding towards insolvency. More work needs to undertaken on this direction.

Legal backing for the prompt corrective action

The Working Group recommends that with a view to maximizing the depositors' and other creditors' welfare in failing banks it is desirable to have legal backing for the prompt corrective action (PCA) regime which has been introduced recently for commercial banks.

Need to clearly define the order of priority of distribution of insolvency assets

The Working Group recommends that a well-defined set of rules for following "priority in distribution" may be framed under the insolvency resolution mechanism. The legal framework in place should explicitly specify the relative priority among the various classes of creditors in case of all the classes of financial institutions.

The Working Group recommends the following order of priority for insolvency estate distribution. All the secured creditors need to be kept out of the insolvency estate. After the costs related to the administration of insolvency process, the immediate priority should be conferred on domestic depositors. Next priority should be bestowed on all dues to employees followed by dues to Government and finally to the unsecured creditors. Depositors should have a floating charge on unencumbered assets of the insolvency estate. The secured creditors' unfulfilled claims, if any, are to be treated at par with the unsecured creditors' claims and may be bestowed the ultimate priority.

Need to give more powers to the liquidator

The Working Group recommends that the liquidator should be empowered to realize the insolvency estate at the 'shortest time' period possible. Legal framework needs to ensure this by removing the constraints to faster liquidation. In this regard the Group recommends that preference should be given to selling the assets even at a discount at the net present value, than preserving the assets for liquidation at a later date. The official liquidator may be provided with adequate staff to facilitate faster realization of insolvency estate.

Need for a distinct and special financial insolvency law

The working Group recognizes the transformation that is taking place in the Indian banking system and the special and exclusive role played by the banks and the financial institutions in the economy. Keeping in view the Indian experience and the experience of others with regard to insolvency of banks, the Working Group recognizes the increasing need for a special financial insolvency law to the Indian financial system and, therefore, recommends that there is a need to evolve a distinct and special financial insolvency law in India, which is efficient, expeditious and equitable that covers all types of financial institutions.

Speedy winding up process for all categories of financial institutions

The Working Group believes that there is a need to thoroughly revisit the existing laws and revamp them with a view to speed up the liquidation process. Considering all relevant issues, the Working Group is of the view that so far the restructuring process of commercial banks in India has been mainly by way of amalgamation and hence the problem of widespread liquidation of banks did not occur. However, with rapid increase in the number of private sector banks the situation would radically change. Against this setting, the Working Group favours evolution of a speedy winding up process for all categories of distressed financial institutions. The insolvency proceedings of UCBs need to be made more efficient by entrusting the work relating to insolvency of banks / UCBs to a separate institutional mechanism, like the proposed Bank Deposits Insurance Corporation (BDIC), as in some of the countries like the US. The reforms could consider providing a legislative framework dealing with the minimum parameters to be complied with, for approving reconstruction schemes. In order to ensure efficiency of the insolvency process, it would be desirable to provide for these aspects in the model law.

Issues related to Payment system

The Working Group recommends that in the face of insolvency, the first claim on collateral given by a payment system participant, (even though not extended to a specific participant, but to the system as a composite whole), is available to other payment system participants.

The Working Group recommends that multilateral net settlement obligations should prevail even in the face of insolvency. The Group notes with satisfaction that this has been taken care of, in the draft Payment and Settlement Bill prepared by the RBI's Committee on the Payment Systems.

The Working Group recommends that close-out netting should be applied to outstanding positions of the insolvent party as soon as the insolvency has been declared.

Cross border insolvency need to be addressed through cooperation with other jurisdictions

If adopted, the UNCITRAL Model law caters to removing current deficiencies and therefore the Working Group endorses the recommendation of the Mitra Committee and the Eradi Committee in this regard that India should consider adopting the UNICITRAL model law on cross border insolvency. The Working Group recommends that in the context of cross border insolvency, while the move towards adopting UNCITRAL is a move in the right direction, it is also desirable to implement the concept of comprehensive consolidated supervision (CCS) and also to put in place a formal or informal protocol of supervisory exchange with other supervisors both domestic and foreign based on mutual cooperation.

The Working Group recommends that in the context of cross border insolvency, while the move towards adopting UNCITRAL is a move in the right direction, it is also desirable to implement the concept of comprehensive consolidated supervision (CCS) and also to put in place a formal or informal protocol of supervisory exchange with other supervisors both domestic and foreign based on mutual cooperation.

Adequacy of exposure norms

In view of the wide coverage as also the flexible approach adopted, the exposure norms currently prescribed are considered to be adequate to address issues such as concentration of risk and credit risk management. In view of the above the Working Group is of the opinion that no changes are required at this stage to the extant 'exposure norms' stipulated for banks. However, a periodic review and monitoring of the extant exposure norms is recommended. In the case of UCBs the Working Group recommends that the exposure norms applicable to small UCBs could be related to their DTL as against the existing norm of linking to the capital funds.

Securitisation arrangements

Although the current provisions do not specifically provide for entering into 'securitisation arrangements' by the liquidator, this itself does not appear to be prohibiting any such arrangements. The Working Group proposes that the framework should explicitly provide for these arrangements, so as to enhance the efficiency of the insolvency regime. The Working Group feels that the current efforts to popularize securitisation are on right direction and should be persevered. In regard to liquidation of collateral, whether the Securitisation Act could facilitate faster realization of the collateral needs to be addressed. NBFCs are not currently covered under the Act. The Working Group recommends that the NBFCs need to be covered under the relevant Act.

Entrusting the resolution of banks' insolvency to the DICGC

The Working Group recommends that the relevant laws need to be modified to expedite the insolvency process and contingent upon that it may be possible in the medium term to consider handling of liquidatorship by the DICGC.

Issues related to 'harmonization'

A perfect harmonization is neither feasible nor desirable. The Working Group believes that there can never be a "one-size fits all" insolvency system. Considering various issues involved in the process of harmonization of domestic laws, the Working Group considers that the issue is not whether our domestic insolvency regime is harmonized with other countries' insolvency regime or not. A more meaningful consideration is whether our insolvency regime is conforming to the features that characterize the regime as efficient, predictable, speedy and equitable so that it can address both domestic and international concerns.

Global financial integration and insolvency

The Working Group feels that the low incidence of bank liquidation in India hitherto is partly explained by the public sector character of a large segment of the financial system hitherto. With gradual privatization and freer operation of private and foreign banks, the pressure of competition could increase the scope for mergers and acquisitions as well as liquidation of insolvent banks. Insolvency regime, therefore, is going to acquire greater importance, and the need for strengthening institutional reforms consistent with the requirements of a market driven financial system would demand that India must aim at putting in place an appropriate financial sector insolvency regime at the earliest.

ANNEX - I

'Insolvency Arrangements and Contract Enforceability' - A Report by the Contact Group on the Legal and Institutional Underpinnings of the International Financial System – Summary.

The Report is the outcome of international initiatives aimed at surveying the work undertaken so far by various International Financial Institutions, to identify gaps and areas of overlap in the operation of insolvency law and contract enforceability. This endeavour is aimed at promoting more robust, transparent and mutually consistent legal institutions and practices relating to financial transactions. On the initiative of the Bank of Italy and the G10 Deputies, a Contact Group composed of interested countries and institutions took up this task. The Report contains no recommendations but advocates further work on bankruptcy reforms.

The basic objective of the Report is to flag various issues raised by the increasing integration of international financial markets and by the emergence of large players whose financial activities span many countries and jurisdictions for the operation of insolvency law, so that required reforms could be contemplated. The main message of the Report is that in tune with the integration of the global financial systems and the increase in attendant risks, it is necessary to ensure that the domestic legal frameworks in vogue are reviewed to ensure that they effectively address the issue of both domestic and cross-boarder insolvencies, which may warrant changes in domestic laws and to some extent harmonization with international bankruptcy legal frameworks.

The Report offers its impressions on national insolvency regimes and the need for coordination to evolve an international insolvency framework. It describes current insolvency law in G-10 countries and its context from an economic perspective. The report evaluates legal rules governing insolvency by three criteria: efficiency of the insolvency process, equity of treatment and reduction of uncertainty. It also discusses law reform efforts addressed to these issues. The first issue identified in the Report is the gap developing between the rapidly changing financial environment in which insolvencies occur and the slower evolution of national insolvency regimes. The second issue stems from the increasing globalization of financial activities and the global scope of financial institutions in a legal environment still defined by national jurisdictions. The third issue is recognition of the fact that many worthwhile insolvency-related reform efforts are already in progress, at both the national and international levels.

The findings of the Report are based on two surveys of insolvency arrangements for financial institutions and financially active non-financial firms and of the treatment of financial contracts under these insolvency arrangements. The framework of analysis used in the Report aim at reduction of legal and financial uncertainty, promotion of efficiency and provision of fair and equitable treatment. Legal certainty and efficiency, and to some extent equity, contribute to lowering liquidity and systemic risks in that they reduce the potential for market disruption and large deadweight losses.

The principal findings of the Report are speedier, market-based insolvency mechanisms appear to better meet the needs of participants in advanced financial markets. Speed in the insolvency process is especially important for credit exposures to insolvent firms in those market segments where risk and liquidity are transferred among large financial market participants. Additional financial arrangements, notably securitisation and outsourcing, appear to facilitate more efficiency and legal certainty in the insolvency process. Differences in national insolvency laws, reflecting national consensus about equity concerns and appropriate insolvency procedures, might create tensions at the international level.

The Report says that it is not its intention that the initiatives suggested should harmonize the relevant substantive laws but to identify best methods of coordination and extend them worldwide through instruments such as a Directive or Convention. Nonetheless, cross-border insolvencies of financial firms and non-financial firms with substantial financial activities will probably continue to rely substantially on empathy among jurisdictions and a high degree of cooperation among supervisors, and the insolvency process is likely to remain costly. Accordingly, much further work along the lines of that already underway could be done over time.

Annex – II

Insolvency – Relevant provisions in the various Statutes

Banking Companies

Applicable Law - Banking Regulation Act, 1949

Section 37 (1) - High Court may on the application of a banking company, which is temporarily unable to meet its obligations make an order of moratorium. No such application is however maintainable unless it is accompanied by a report of RBI indicating that in RBI's opinion the bank will be able to pay its debts if the application is granted.

(3) – When a banking company is under moratorium as per Section 37(1), the High Court may appoint a special officer who shall forthwith take into his custody or under his control all the assets, books, documents, effects and actionable claims to which the banking company is or appears to be entitled and shall also exercise such other power as High Court may deem fit to confirm on him, having regard to the interest of the depositors of the banking company.

Section 38 - This section provides for compulsory winding up in the circumstances mentioned therein; namely, when the banking company is unable to pay its debts; or if an application for its winding up is made by RBI on the specified grounds. In terms of sub-section (4), a banking company is deemed unable to pay its debts if it has refused to meet any lawful demand made at any of its offices or branches within the specified period of two/five working days.

Section 38A(1) - As per this Section, there shall be a Court Liquidator attached to every High Court to be appointed by the Central government for the purpose of conducting all proceedings for the winding up of banking companies and performing such other duties in reference thereto as the High Court may impose.

Section 39 - On RBI's application, RBI, SBI, any bank notified in this behalf or any individual mentioned in the application shall be appointed as the official liquidator.

Section 39A - All the provisions of the Companies Act relating to a liquidator, in so far as they are not inconsistent, apply to or in relation to a liquidator appointed under section 38A/39.

Section 41 - Preliminary report by official liquidator – Where a winding up order has been made in respect of a banking company, the official liquidator shall submit a preliminary report to the High Court within two months from the date of winding up order stating the amount of assets of the banking company in cash which are in the custody of the liquidator on the date of report and the amount of its asset which are likely to be collected in cash before the expiry of that period of two months so that such assets may be applied speedily towards the making of preferential payment under Section 530 of the Companies Act, 1956 and in discharge as far as possible of the liabilities and obligations of the banking company to its depositors and other creditors in accordance with the provisions contained under the Act. The official liquidator shall make for the purpose aforesaid every endeavour to collect in cash as much as of the assets of the banking company as practicable. This provision is notwithstanding anything to the contrary in Section 455 of the Companies Act.

Section 41A - Notice to be issued to preferential claimants and secured and unsecured creditors - issue of notice is required to be made by the official liquidator within fifteen days of the winding up order of a banking company for the purpose of making an estimate of the debts and liabilities of the banking company (other than its liabilities and obligations to its depositors). The notice has to be served in such manner as the Reserve Bank may direct. As per sub-section (4) if a claimant fails to comply with the notice sent to him under sub-section

(1), his claim will not be entitled to be paid under Section 530 of the Companies Act in priority to all other debts but shall be treated as an ordinary debt due by the banking company; and if a secured creditor fails to comply with the notice sent to him under sub-section (1), the official liquidator shall himself value the security and such valuation shall be binding on the creditor.

Section 42 - empowers the High Court to dispense with any meeting of creditors or contributors.

Section 43 - Booked depositors' credits to be deemed proved – In any proceeding for the winding up of a banking company, every depositor of the banking company shall be deemed to have filed his claim for the amount shown in the books of a banking company as standing to his credit and notwithstanding anything to the contrary contained in Section 474 of the Companies Act, the High Court shall presume such claims to have been proved unless the official liquidator shows that there is reason for doubting its correctness.

Section 43A - Preferential payments to depositors – Once the preferential payments are made by the official liquidator in respect of which statements of claims have been sent within one month from the date of service of notice referred to in Section 41A as per Section 530 of the Companies Act or adequate provision for such payments have been made, there shall be paid within three months – (a) in the first place, to every depositor in the saving bank accounts of the banking company a sum of Rs.250/- or the balance at his credit, whichever is less; and thereafter (b) in the next place to every depositor of the banking company a sum of Rs.250/- or the balance at his credit, whichever is less, in priority to all other debts from out of the remaining assets of the banking company available for payment to general creditors.

Provided that the sum total of amounts paid under clause (a) and clause (b) to any one person who in his own name (and not jointly with any other person) is a depositor in the saving bank account of the banking company and also a depositor in any other account, shall not exceed the sum of Rs. 250/-.

As per sub-section (3), where within the aforesaid three months period, full payment cannot be made of the required amount to be paid under clause (a) or clause (b) of sub-section (2) with the assets in cash, the official liquidator shall pay within that period to every depositor under clause (a) or as the case may be clause (b) of that sub-section on pro rata basis so much of the amount due to the depositor under that clause as the official liquidator is able to pay with those assets; and shall pay rest of that amount to every such depositor as and when sufficient assets are collected by the official liquidator in cash.

As per sub-section (4), after payments have been made first to the depositors in the saving bank account and then to other depositors in accordance with the foregoing provisions, the remaining assets of the banking company available for payment to the general creditors shall be utilized for payment on pro rata basis of the debts of the general creditors and the further sum if any due to the depositors after making adequate provision for payment on pro rata basis as aforesaid of the debts of the general creditors. The official liquidator shall as and when the assets of the company are collected in cash, make payment on a pro rata basis as aforesaid, of further sums if any which may remain due to the depositors referred to in clauses (a) and (b).

As per sub-section (5), in order to enable the official liquidator to have in his custody or under his control in cash as much of the assets of the banking company as possible, the securities given to every secured creditor may be redeemed by the official liquidator as provided therein provided that where the official liquidator is not satisfied with the valuation made by the creditor he may apply to the High Court for making a valuation.

As per Sub-section (7), the following shall be treated as payments of a different class, viz. (a) payment to preferential claimants under Section 530 of the Companies Act; (b) payment under clause (a) of sub-section (2) to the depositors in the savings bank account; (c) payment under clause (b) of the sub-section (2) to other depositors; (d) payment to the general creditors and payment to the depositors in addition to those specified in clause (a) and clause (b) of sub-section (2).

As per Sub-section (8), the payments of each different class specified above shall rank equally among themselves and be paid in full unless the assets are insufficient to meet them, in which case they shall abate in equal proportion.

As per Sub-section (9), nothing contained in sub-sections (2), (3), (4), (7) & (8) shall apply to the banking company in respect of the depositors of which the DICGC is liable under Section 16 of the DICGC Act, 1961.

As per sub-section (10), after the preferential payments referred to in sub-section (1) have been made or adequate provision has been made in respect thereof, the remaining assets of the banking company referred to in sub-section (9) available for payment to the general creditors shall be utilized for payment on pro rata basis of the debts of the general creditors and of the sums due to the depositors.

Provided that where any amount in respect of any deposit is to be paid by the liquidator to DICGC under Section 21 of the DICGC Act, only the balance if any left after making the said payment shall be payable to the depositors.

Section 44 – deals with the powers of High Court in voluntary winding up.

Section 44A - lays down the procedure for voluntary amalgamation of banking companies.

Section 45 - empowers RBI to apply to Government for imposition of moratorium and to prepare scheme of reconstitution or amalgamation.

Section 45B – Power of High Court to decide all claims in respect of banking company.

Part IIIA contains special provisions for speedy disposal of winding up proceedings. These inter alia include, Settlement of list of debtors, making calls on contributories, documents to be evidence, etc.

Non – Banking Financial Companies

Reserve Bank of India Act, 1934

Section 45MC – empowers the Bank to file petition for winding up of an NBFC. As per sub-section (4), all the provisions of the Companies Act, 1956 relating to winding up of a company shall apply to winding up proceedings initiated on the application made by the Bank under this provision.

Statutory corporations

Industrial Development Bank of India Act, 1964

Section 36 – Liquidation of Development Bank – No provision of law relating to the winding up of companies or corporations shall apply to the Development Bank and the Development

Bank shall not be placed in liquidation save by order of the Central Government and in such manner as it may direct.

Small industries Development Bank of India Act, 1989

Section 51 - Liquidation of the Small Industries Bank – Same as for IDBI

State Bank of India Act, 1955

Section 45 – Bar to liquidation of State Bank – Same as above

-////-