BANKING AND Securitization POISED FOR CHANGE

The recent enactment of the Banking Laws (Amendment) Act, 2012, and the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012, should provide a stimulus to this sector

Making light of widespread criticism accusing the Union Government of policy paralysis, the year 2013 has started on an optimistic note for the banking and financial services sector. At a time when analysts were concerned about inculcating measures to dispel recessionary headwinds from developed economies, the recent enactment of the Banking Laws (Amendment) Act, 2012 ('**Banking Amendment Act**') and the Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012 ('**Securitization Amendment Act**') should give a stimulus to banks and securitization companies. In this article, we take a look at some of the measures introduced by these twin amendments.

The Banking Amendment Act - striving for world class banks

The Banking Amendment Act makes several significant changes to existing banking legislation, namely the Banking Regulation Act, 1949 (‘**Banking Regulation Act**’), the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. One of the principal aims of the Banking Amendment Act is to vest additional powers in the Indian banking regulator, the Reserve Bank of India (‘**RBI**’), paving the way for entry of new players in the banking sphere and resulting in greater competition, efficiency and wider financial inclusion.

Capitalizing on reforms

New banks will have an authorized share capital of ₹30 billion, comprising 3 billion fully paid-up shares of ₹10 each, twice the previous limit of ₹15 billion. Banks desirous of varying the number and denomination of its shares are required to obtain the permission of the RBI. The Government, in consultation with the RBI, also has the power to increase or decrease the authorized capital limit.

Banks will now have the freedom to issue preference shares (which was not permitted earlier) subject to compliance with guidelines to be framed by the RBI. While preference shares under the Companies Act, 1956 enjoy limited voting rights, the Banking Amendment Act stipulates that preference shares issued by banks, will not be allowed to carry any such right.

Besides private placement and public issue, alterations to paid-up capital may now also be carried out by nationalized banks through issuance of bonus shares or a rights issuance. These methods may enable banks to raise capital without material deviation from subsisting shareholding patterns.

Voting ceilings set higher

The systemic importance of banks in the financial system, coupled with the dangers of their managerial control being concentrated in the hands of few, had led to the imposition of voting caps (irrespective of shareholding) of 1% for public-sector banks and 10% for private-sector banks.

The Banking Amendment Act now raises this threshold for public sector banks to 10%. The RBI has also been vested with the authority to increase the voting cap imposed

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upon private banks progressively upto 26%. This measure is likely to give a fillip to transparency and corporate governance standards. It is also been viewed as a sweetener, calculated to woo serious investors (especially foreign investors) as they can now have a greater say in the decision-making process of the banking institutions of which they become shareholders.

To counteract any negative fallout from the above dispensation, the acquirer of shares is required to obtain the prior approval of the RBI before undertaking any transaction which would result in a party, either directly or indirectly, acquiring 5% of shares or voting rights in a banking company. Key to obtaining such approval is the determination by the RBI as to whether the potential acquirer is a "fit and proper person", which is based on several parameters such as international best practices, predominant banking trends and public interest.

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Regulatory domain widened

As a prerequisite to acting upon the finance minister's 2010 Union Budget proposal to grant banking licences to new players, the RBI had requested greater supervisory powers, which the Government has provided it with in the Banking Amendment Act.

In addition to its existing powers to remove any director or officer of a bank, the RBI, in consultation with the Union Government, may in the interest of the public or shareholders, supersede a bank's board of directors and appoint an administrator in its place, for a term of not more than six months. The term may be extended by the RBI, provided the cumulative period of supersession does not exceed twelve months.

The ambit of supervisory authority of the RBI has been extended, with the regulator now being entitled to call for financial statements and other information relating to 'associate enterprises' of banks. This term, as introduced in the Banking Amendment Act, includes subsidiaries, holding companies, joint ventures or other entities having control over the bank or deriving economic benefits from its activities.

While such power could aid in detecting and preventing fraud in the context of banks licenses being granted to industrial houses with diversified commercial interests, the manner of its exercise may be a concern. To obviate the outbreak of regulatory turf wars, the Banking Amendment Act mandates that inquiries into associate enterprises be conducted hand in glove with the appropriate authority, if any, which would ordinarily supervise such entity.

The ripple effect

The Banking Amendment Act also includes consequential changes made to other statutes, one such change being in relation to the Indian Contract Act, 1872 ('**Contract Act**'). An exception has been inserted to the general stipulation made in Section 28, which renders void any restriction to legal enforcement of contractual rights.

The above amendment seeks to clarify that a provision in a guarantee for extinguishment of the rights or discharge of any party from liability under the guarantee on the expiry of a specified period is not illegal by virtue of Section 28 of the Contract Act, so long as such period specified is not less than one year from the date of occurring or non-occurring of a specified event that triggers such extinguishment or discharge of liability.

Another noteworthy change, aimed at arousing the interest of global players to enter the lucrative Indian banking industry, is the amendment of prevailing revenue laws to exempt payment of stamp duty certain transactions, including conversion of a branch office into a wholly owned subsidiary and the transfer of shareholding of a bank to its holding company.

The Securitization Amendment Act - a new hope?

The Securitization Amendment Act, which came into force around the same time as the Banking Amendment Act, aims to remove some bottlenecks observed in the existing framework for recovery of non-performing assets ('**NPA**') - namely, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 ('**RDB Act**'), and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('**SARFAESI Act**').

Power to co-operatives

The Securitization Amendment Act includes multi-state co-operative banks ('**MSCB**') within the ambit of "bank" as defined by the RDB and the SARFAESI acts. This amendment was required in light of a contrary ruling by the Supreme Court of India in *Greater Bombay Co-operative Bank Limited v MS United Yarn Textiles Private Limited*.

A consequence of the above amendment is that MSCBs will now have the option of accessing remedies

for recovery under the RDB Act and the SARFAESI Act, besides those available under the Multi-State Co-operative Societies Act, 2002. This measure could also provide a stimulus to asset reconstruction, as MSCBs may now assign NPAs to asset reconstruction companies ('**ARC**').

More doors open for creditors

The Securitization Amendment Act now allows ARCs to convert any portion of acquired debt component into shares of the borrower company. This measure could permit ARCs to have a greater say in the borrower's management, and allow a profitable exit in the event of a successful turnaround. From a borrower's viewpoint, resources can now be utilized for productive purposes rather than debt servicing. Currently, rules on the finer points of such conversion are still awaited.

On the flipside, conversion is a long term recovery strategy which entails belief in the fundamentals of the borrower. Additionally, an ARC would also lose its status as a secured creditor upon conversion of the entire debt component and would no longer be entitled to a charge in the event of liquidation of or asset sale by the company.

Another significant measure introduced by the Securitization Amendment Act is that it enables creditors to adjust outstanding debt by acquiring secured property in its own name in the event of failure to obtain the reserve price in an auction process. This is especially true for situations where it is suspected that participants are colluding with or acting at the behest of the borrower, thereby frustrating genuine price discovery.

This amendment is a permitted exception to the general restriction which prevents banks from acquiring immovable property. However, the provision is subject to the Banking Regulation Act, which requires that such property, acquired otherwise than for a bank's own use, be disposed of within seven years or such extended period as permitted by the RBI.

Ironing out creases

The Securitization Amendment Act also addresses several procedural roadblocks in the existing regulatory framework. For example, the process for substitution of the original debtor by an acquiring party in matters pending before debt recovery tribunals has been streamlined by providing for an application mechanism, to be filed by the acquirer before the applicable tribunal.

The number of adjournments which may be sought by a party in a recovery proceeding is now capped to three. Caveats may also be employed in recovery proceedings before various fora to enable lenders to be heard prior to orders being passed.

The act also mandates registration of Securitization transactions under a central registry accessible to financial institutions, thereby facilitating the detection of fraud.

Takeaways for the Financial Services Sector

With the twin amendments, it is hoped that recovery by banks will step up and help keep NPA levels in check. The push for penetration of banking services and wider financial inclusion would also be benefitted by these legislations. Another developing story in the wake of the enactments is the RBI recently issuing guidelines on licensing of new banks in the private sector, with applications invited from interested parties by July 1, 2013. Clearly, the Indian banking and securitization sector is poised to grow by leaps and bounds in the near future.

Conversion of debt could permit ARCs to have a greater say in the borrower's management, and allow a profitable exit in the event of a successful turnaround. From a borrower's viewpoint, resources can now be utilized for productive purposes rather than debt servicing

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