CHANGING DYNAMICS OF LEGAL RISKS IN FINANCIAL SECTOR

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The word "Legal Risk" has never been defined per se in any of the dictionaries or even in Law Lexicon. However, the word "risk" has been defined not only in the English Dictionary but also in the Law Lexicon. The word risk as is commonly understood from a financial sector's point of view is different from the word "risk" as is understood in the common parlance. However, at all times the word "risk" involves the uncertainty and danger or an untoward incident that may follow the action. Therefore, we may look at the definition of the word "risk" as appearing in the Oxford Dictionary,[1] wherein the term "risk" is defined as a situation involving exposure to danger or the possibility that something unpleasant will happen. It is also an exposure not only to danger but to loss. Further, legal dictionary Law Lexicon[2] defines "risk" as a chance or hazard of commercial loss.

From the above definition, it is clear that if one is to look at the definition from the point of view of the financial sector, it always denotes the relationship to loss that may happen. However, the chance of minimizing such legal risk in financial sector is what we are aiming to look at and explain in this article. As stated supra, since there is no clear-cut definition of "legal risk", we have to go on certain assumptions in defining the word or the term legal risk. One of the definitions by McCormick is as under:[3]

> "(1) a defective transaction; (2) a claim (including a defense to a claim or a counterclaim) being made or some other event occurring which results in liability for the company or other loss; (3) a failure to adequately protect assets owned by the company; or (4) change in the law."

Another way of looking at it from the plain interpretation of the word "legal risk" is the risk arising from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulation depending on the institutional circumstances. Another way of defining the term, is description of potential for loss arising from uncertainty of legal proceedings and potential legal proceedings that may befall on the company due to erroneous, casual or hasty action. In the Indian context, the Apex Court in the case of Narasimha Rao[4] has held that "However high one is, law is above him".

The above dictum as held by the Hon'ble Court clearly establishes a supremacy of law and therefore it is to be always kept in mind that under the financial sector while we may contain all the other possible risks, equally important is the legal risk involved in the transaction. If the legal risk or the potential legal risk is not seen and addressed at the initial stage or even at the appropriate stage, inspite of the fact that we may address all other risks, we cannot escape the rule of law

1 *The Concise Oxford Dictionary*; 10th Edition, Oxford University Press, 1999, Edited by Judy Pearsall.

2 Ramanatha Aiyer P., *The Law Lexicon, The Encyclopedic Law Dictionary*; 2nd Edition (Reprint) 2001, Wadhwa & Company Nagpur, India.

3 http://lawdepartmentmanagement.typepad.com/law_department_management/2006/06/a_definition_of.html as on 29th September, 2009.

4 *P V Narasimha Rao v. State (CBI/SPE)*; AIR 1998 SC 2120.

which may end up in the potential legal proceedings and may cascade itself into umpteen legal proceedings or even in filing proceedings for liquidation and bankruptcy.

In the financial sector, especially in the Banking sector, the changing dynamics of legal risk was borne by the fall of the mighty financial institutions. To quote from the legal judgment passed by the Hon'ble Madras High Court in M/s.Rajshree Sugars & Chemicals Limited v. M/s. AXIS Bank Limited:[5]

> *"$ 700 Billion bail out plan", "Wall Street vanished", "Lehman Brothers went belly up", "Bear Stearns consumed", "U.S. National Debt Clock runs out of digits" and "AIG gone up in smoke" are some of the captions which have hit the headlines in recent times. All of those news items have a common denominator, called derivatives"*

The root cause of all these bankruptcy proceedings in my opinion was due to the fact that legal system failed to recognize the legality and the enforceability and the legal risk involved in the contracts, namely derivative contracts or exotic contracts which was entered into by these financial institutions.

Equally in India also with the fall of these mighty financial institutions, legality or legal risk involved with the transactions of similar nature were put to test or being tested even today. Since the matter is subjudice and considering the fact that even though the Banks have won in the first round, and since the proceedings have not come to finality I am not commenting on the legality of these issues in this Article.

As a in-house legal counsel of a Bank, I would like to discuss changing dynamics of legal risk with respect to Bank's in India. For this purpose, I need to draw reference to the Banking Regulation Act, 1949. The said Act being the Bible for the bankers especially with respect to the businesses it can undertake, has always reference to Section 6 of the Banking Regulation Act, 1949.

About two decades ago, banking was also limited to certain transactions which includes mainly those transactions defined under Section 6 (a) to 6 (m) of the Banking Regulation Act, 1949. With the changing scenario and with the economy opening up, Reserve Bank of India in its capacity as the controller and regulator of the Banking system allowed or in fact explored the possibility of looking into business, which can be fitted into Section 6 (n) and (o) of the Banking Regulation Act, 1949. When the said two sections were interpreted by Reserve Bank of India in a liberal manner, it had opened a floodgate of opportunities for the Banking Sector. Thereafter, irrespective of the fact that whether it is a bank established under a private sector or a public sector, the bank saw this golden opportunity to earn fee income and started transacting and walking through the virgin paths which were hitherto unknown in banking industry.

This also threw up an opportunity for the banking sector as a whole to look into or examine the legal risk involved in such a virgin transactions as allowed by the regulator. We are not forgetting the fact that the regulator at all times examined potential risk involved in these transactions and had given the guidelines which banks should strictly follow while doing business in these new products which were allowed because of economic liberalization.

Traditionally if one looks at legal risk which is involved in a financial institution, it arises from the following items:

a) Product Liability Risk
b) Compliance Default Risk

While some other risks like employee liability and tax compliance risks, are also associated with such risk of the financial sector, the most important risk to be considered is the product liability risk. The product liability risk as is understood today is the risk involved in marketing or selling the product, by any institution be it a manufacturing unit or financial institutions. The product, which

5 Madras High Court Judgment dated 14th October, 2008.

is passed on to the ultimate customer, always carries the inherent risk. The sum total of all other risks involved in the products cascades into legal risk at the end of the day. Therefore as far as a financial institution is concerned, legal risk is the most important risk, which is to be addressed vis-à-vis a product liability risk.

We will now examine as to how such product liability risk evolves. As stated earlier, since Reserve Bank of India has allowed the Banks to branch out certain new forms of business, Banks shall always be eager to come out with new products. While coming out with such products, at the inception stage itself, legal risk which needs to be addressed is as under:

a) It has to look into the fact whether the products so evolved are in compliance with the rules and regulations laid down by the regulators. This naturally involves interpretation of the rules laid down by the regulators. Interpretation always differs and is in doubt while it is the best way to seek clarification from the originators of the rules and regulations, in practicability it is not an easy way to do business because it involves or turns out to be a spoon feeding method and may end up giving an impression that the regulator itself is doing business through its controlled arms.

b) The other risk involved is the compliance risk. The compliance risk is also equally important for the simple reason that for the growth, stability and financial health of a Nation, it is necessary to ensure that the compliance risk is always addressed because in state where no rule of law prevails the financial sector shall never grow. The compliance is monitored by the regulators who make rules and regulations. For example it is Reserve Bank of India, as far as Banks are concerned and as far as other Institutions are concerned it may be their respective regulations. Therefore in this type of risk, it is necessary for the financial institutions and banks to ensure that they are in compliance with the regulator's guidelines, not only in spirit but also in letter. However, the dynamics of this risk is not stable. It is ever changing for the simple reason that as business evolves, the regulators may see through the compliance risk in a different manner altogether. Therefore the compliance as may be applicable on a particular period of time, may differ in subsequent period, if the business pattern has thrown up certain new developments and which needs to be addressed by the regulators from compliance point of view.

We have a tendency at all times to assume or even copy certain best practices which are practiced abroad on the assumption that they are the best in the industry. However, with the fall of mighty organizations abroad, which were supposed to have followed best practices, the said myth has been given a go off. A classic example is a fact that while banking institutions all over the world fell like pack of cards, Indian financial industry withstood the storm. In this case, we will be forgetting our duties, if we are not to quote Dr. Y.V. Reddy, former Governor of Reserve Bank of India:

> *"I cannot define God, but I can recognise the devil, and whenever I see the devil, I take precautionary measures to avoid being affected."*

In conclusion what we want to say is that the dynamics of legal risk in ever changing financial market cannot be placid. It has to create ripples. Therefore it cannot be measured in terms of set of tools and yard sticks nor can one lay down certain set patterns to measure a fathom the legal risk involved in the transaction at all times. What we need to do is to take proactive legal risk management system and for this purpose, the role of in-house legal counsel or Law Department assumes a greater importance than it was. Today the role of in-house legal counsel is not limited to approving legal documents or transactions, as it was understood in the traditional manner. It is necessary for the business department to involve and initiate an in-house legal department into business transactions at the inception stage itself without which the in-house legal counsel may not be in a position to address a legal risk involved in the product because he needs to understand the transaction per se before assessing the legal risk involved in it.

Only a lawyer or an in-house counsel who

understands the business can assess the legal risk in a full manner otherwise it will end up like seven blind men seeing an elephant. For example in cross-border transactions to assess the legal risk one need to know the working of multiple legal systems. This demands need to address multiple legal systems, languages and time zones that can significantly complicate challenges. Substantive differences between the laws and legal systems of different jurisdictions create many issues that require attention and are to be assessed upfront when the transaction is structured. Hence, involvement of in-house counsel from the beginning is vital.

There are two ways of addressing the legal risks one way is to assess the potential legal risk involved in a transaction at the time of inception of the product. The other is to wait till a risk is sighted in reality and addressing the same subsequently. Wise men follow the first one as it reduces the risk at the inception. Perhaps, one may even accuse the in-house legal counsel of being pessimist.

To quote from the Article regarding the proactive legal risk management as appears in Business Line, Edition October 26, 2006 by Mr. Anand Shankar Jha.

"Legal risks do not arise in vacuum, but owe their origin either to business operational loopholes or to subsequent breach of the manner a product or service is offered. Most legal departments within companies are deployed with the purpose of fighting and managing legal risks once they have arisen, meaning, the remedies deployed are often always reactions. Pre-emptive legal risk management, however, would imply taking a proactive role in understanding the nuances of the business, honing the capability to juxtapose the actions/omissions of the business on to a legal sphere, foresee potential legal repercussions of such acts and prepare possible remedies to avoid that risk.

Though there can never be fixed sets of rules on how to devise pre-emptive strategies, the basic principle remains common - the exercise must involve analytical questioning of the impact of the business process on various actors. Sample the following list of questions: Is there a possibility of the business violating some law indirectly or unintentionally though most applicable laws have been complied with? What is the likelihood of the end product or service hurting any legal right of consumers? Are the internal data security measures deployed capable of infringing any employee rights? Is the company's model of growth in different countries compliant with competition laws of the respective local jurisdictions?Is there a need to lay down standards governing employee-client or employee-third party communications so that proprietary or confidential information remains guarded?"

In the scheme of things, considering the fact that inspite of the great amount of compliance and control and inspite of following best practices, institutions, which were in existence for 100 to 200 years, have vanished into thin air. It is upto the in-house legal counsel to ensure that in this ever changing financial sector, where innovations are the rule of the day, he has to keep himself abreast not only with the latest legal solutions, but has to find out and assess the legal risk involved in a transaction and has to join hands with business departments in finding solutions and allowing business departments to do business albeit to ensure that under no circumstances such business transactions, be it a contract, be it a product or any financial business tool, will hurt the company and lead to the company being put to irreparable loss including bankruptcy. While interpreting the regulatory rules, in-house legal counsel needs to take rigid but straightjacket approach while interpreting the words and phrases without getting swayed by the business department's pressure.

Equally since the concept legal risk is changing fast with the circumstances related to each product or transaction, in assessing the legal risk one should approach the said issue with an open mind. If not we shall fail to understand the legal risk and may become redundant. I am tempted to quote Mahatma Gandhi:

> *"It is unwise to be too sure of one's own wisdom. It is healthy to be reminded that the strongest might weaken and the wisest might err."*