KARNATAKA STATE OPEN UNIVERSITY

Mukthagangothri, Mysore – 570 006

M.B.A.

MASTER OF BUSINESS ADMINISTRATION

FOURTH SEMESTER

LAW OF BANKING

COURSE: MBSC-4.1F **BLOCK: 1 TO 4**

DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

KARNATAKA STATE OPEN UNIVERSITY

MUKTHAGANGOTHRI, MYSURU- 570 006.

DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A IV SEMESTER

COURSE - 4.1F

LAW OF BANKING

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BLOCK-I

UNIT-1: THE ARCHITECTURE OF INDIAN FINANCE SECTOR

Structure:

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1.0 OBJECTIVES

- To understand the meaning of financial system and different components of Indian Financial System.
- To know the the origin of modern banking in India, nationalization and opening up of Indian banking sector.

1.1 INTRODUCTION

Financial sector of India denotes the complex set up formed by all the interrelated parties, institutions and regulators, who have a part or are closely connected with the system providing the connecting link between the investors and the consumers or savers. Guruswamy defines it as "a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions." It consists of institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment, and providing facilities, including payment systems, for the financing of commercial activity. The significance of financial sector in India or for that matter in any country needs no explanation, since every modern day commercial activity requires financing. The strength of the economy in a country is dependent on the availability of finances for its industries and business enterprises. The developing country like India is in definite need of strong support from both public and private financial sectors.

1.2 COMPONENTS OF INDIAN FINANCIAL SECTOR

The Regulators – Regulation of human activities is inevitable due to the possible expansion of such activities beyond the legal limits. The regulators play the significant role of confining the human activities within the permissible limits. Indian financial system is regulated by a number of independent regulators in the sectors of banking, insurance, competition, capital markets and various services sectors. The key regulators are the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority, Forward Markets Commission and Ministry of Finance.

The Markets – Financial markets are the places where individuals engage in any type of financial transaction. With the advent of computer and Internet, the markets are increasingly becoming virtual, where the transactions take place online. The financial transactions in the markets include buying and selling of financial assets such as equities, bonds, currencies and derivatives. Some of the main financial markets are commodities market, equity market, debt market and foreign exchange market.

The Players – Finally, the most significant component of the financial sector is the players. The players in the financial markets range from those who are involved in lending to those who are involved in borrowing. The long list of people in between these two extreme ends also play significant role in the markets. Brokers, firms, banks, financial institutions, foreign institutional investors, mutual fund managers, investors, exchanges, depositories, custodians and registrars are the main players of the financial market.

1.3 THE REGULATORS

1.3.1 Reserve Bank of India (RBI)

RBI stands at the centre of India's financial system and formulates the monetary policy relating to Indian Rupee. Upon the recommendation of Hilton Young Commission, the RBI was established on 1 April 1935 under the Reserve Bank of India Act 1934 with an objective of responding to the economic crisis existed during the great depression of 1930s. Though the RBI was owned by the private shareholders in the beginning, it has become a public body after the nationalization in 1949. Initially it was headquartered in Calcutta (Kolkata) and later, it was moved to Bombay (Mumbai) in 1937. It stands as the investment bank for the government, which is responsible for regulating and performing a number of key functions including regulating deposit-taking agencies, regulating debt and foreign exchange market and a host of other functions. The RBI itself describes its functions as 'extending beyond the functions of a typical central bank' and includes –

(a) Monetary Activity
(b) Issuer of Currency
(c) Banker and debt manager to government
(d) Banker to Banks
(e) Regulator of the Banking System
(f) Manager of Foreign Exchange
(g) Maintaining Financial Stability
(h) Regulator and Supervisor of the payment and Settlement Systems
(i) Developmental Role

1.3.2 Forward Markets Commission (FMC)

Forward Markets Commission is a statutory body headquartered at Mumbai responsible for the regulation of commodity derivative market and commodity derivative brokers. Set up in 1953 under the Forward Contracts (Regulation) Act 1952, it is overseen by the Ministry of Consumer Affairs, Food and Public Distribution, Government of India. It

plays a very important role in the development and regulation of commodity derivative market. As per the estimations, by 2009, the Commission has regulated ₹52 trillion worth of commodity trade in India. This clearly indicates the significance of the FMC in India. Currently the FMC allows commodity trading in 21 exchanges in India. It performs a number of functions in this direction.

(a) It advises the Central Government regarding the recognition or withdrawal of recognition of any association or relating to any issues arising out of the Forward Contracts (Regulation) Act 1952.

(b) It constantly keeps a watch on the forward markets and takes appropriate actions relating to them in the exercise of powers assigned to it by or under the Forward Contracts (Regulation) Act 1952.

(c) The FMC collects the information relating to trading conditions of goods, which are subject to the provisions of the Forward Contracts (Regulation) Act 1952, and if necessary, it publishes such information. It also submits the periodic reports to the Central Government on the working of forward markets relating to such goods.

(d) It makes recommendations for improving the organization and working of forward markets.

(e) The FMC also holds the inspection of accounts and other documents of any recognised association or registered association or any member/s of such association.

1.3.3 Securities and Exchange Board of India (SEBI)

Securities and Exchange Board of India was established in 1992 in accordance with the provisions of the Securities and Exchange Board of India Act 1992. Basic function of SEBI has been provided in its preamble as "...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto". The chief functions of SEBI include –

(a) Regulating the business in stock exchanges and any other security markets.

(b) Registering and regulating work of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers and other intermediaries connected with securities market.

(c) Registering and regulating working of depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and other intermediaries.

(d) Prohibiting fraudulent and unfair trade practices relating to security market.

(e) Promoting investors education and training of intermediaries of securities market.

(f) Registering and regulating work of venture capital funds and collective investment schemes.

The SEBI, being the regulator, is authorised to make rulings on any of the above mentioned aspects to implement its functions. Grievances and appeals to SEBI rulings are heard by Securities Appellate Tribunal.

1.3.4 Ministry of Finance

Ministry of Finance plays a vital role in creating regulators. Ministry acting through a number of Departments like Department of Economic Affairs, Department of Expenditure, Department of Revenue, Department of Disinvestment and Department of Financial Services is responsible for looking at broader issues of policy formulation. Few of the chief functions of the Ministry are:

(a) Administration of Foreign Exchange Management Act 1999.

(b) Looking into the matters relating to foreign aid for economic development, domestic finance, budget etc.

(c) Administering all matters relating to Central Board of Excise and Customs and Central Board of Direct Taxes.

(d) Administering all matters relating to disinvestment of Central Government equity from Central Public Sector Undertakings.

(e) Looking into matters relating to policy relating to general insurance, administration of the Insurance Act 1938.

(f) Administration of all matters relating to Indian bank, foreign banks (so far as their operation in India is concerned), Reserve Bank of India, Cooperative Banking and matters concerning All India Development Financial Institutions.

1.3.5 Insurance Regulatory and Development Authority (IRDA)

IRDA is the regulating body of insurance sector and aims to protect the interests of policyholders. The recommendation of the Malhotra Committee report in 1994 set the tone for the establishment of IRDA. It is a ten member body consisting of a Chairman, five whole-time members and four part-time members. It is entrusted with the task of ensuring speedy and orderly growth of the insurance industry. In this direction, it performs a range of functions listed below.

(a) Protection of the interest of policyholders and securing their fair treatment.

(b) To bring about speedy and orderly growth of insurance industry and to provide long term funds for accelerating growth of the economy.

(c) Setting, promoting, monitoring and enforcing high standards of integrity, financial soundness, fair dealing and competence of those it regulates.
(d) Ensuring the speedy settlement of genuine claims and preventing insurance fraud and other malpractices. Towards these ends, the IRDA has the obligation to establish effective grievance redressal machinery.
(e) Promotion of fairness, transparency and orderly conduct in financial markets dealing with insurance.
(f) Regulating professional organizations connected with insurance and re-insurance business.

1.3.6 Pension Fund Regulatory and Development Authority (PFRDA)

Established by Government of India on 23 August 2003, PFRDA is responsible for regulating the pension sector. The major impetus for the establishment of PFRDA was the Government's efforts to find a suitable solution to the problem of providing adequate income to the people after retirement. It performs four main functions among others. First, regulation of National Pension System (NPS), which is scheme launched for all citizens of India, including the people in the unorganized sector, with effect from 1 May 2009. Second, educating the subscribers and general public on the issues relating to pension. Third, training the intermediaries on issues relating to pension. Fourth, acting as the adjudicating body for settlement of disputes cropping up between intermediaries themselves and between the intermediaries and the subscribers. With the performance of these tasks, PFRDA has been hailed for its success in the development of sustained and efficient voluntary contribution based pension system in India.

1.4 THE MARKETS

1.4.1 Commodity Market

Commodity market is a physical or virtual market place where buying, selling and trading of primary products takes place. There are more than 100 primary commodities which are traded globally. Commodities traded can be roughly subdivided into hard and soft commodities. Hard commodities refer to those that are extracted and include natural resources such as gold, rubber, oil etc. Soft commodities refer to those that are harvested and include primarily agricultural products such as coffee, sugar, soybeans, wheat, corn etc. Livestock such as pork and fruits are also tradable commodities.

Trading in commodities market takes place via financial derivative, which is a financial instrument deriving its value from the commodity. Derivatives can either be exchange-traded derivatives or over-the-counter derivatives. Few major forms of derivatives are:

(a) Forward contracts:

Forward contract is an agreement between two parties to exchange a fixed quantity of commodity at a fixed future date for a price which is fixed on the date of entering into the contract. The said price is known as the forward price.

(b) Futures Contract:

Futures contract are exchange traded contract which require delivery of a commodity at a specified price on a specified future date. Future contracts are forward contracts as the exchange is to take place at a fixed future date. However, they are always traded in standardized form via an exchange.

(c) Swaps:

In case of swap there are two underlying financial contracts for exchange of which a financial contract is entered into. The duration of swap is known as the maturity period. Swap again is of various types like currency swap, interest rate swap, equity swap etc. Swaps are carried out over the counter as these are custom – made agreements between two parties.

(d) Options Contract:

Option contracts provide for buying or selling specific commodities, financial products etc. They contain a specific price known as the strike price and a expiration date beyond which they have no value. They are of two types – calls and puts. Under calls, the buyer has the right but not the obligation to buy a given quantity of an underlying commodity on or before the given future date (expiration date). In case of put, the buyer has the right but

not the obligation to sell a given quantity of an underlying commodity on or before the expiration date.

(e) Exchange Traded Commodities (ETC):

Exchange Traded Commodities are open ended financial vehicles which track performance of underlying commodity and can be either single commodity ETC or index-tracking ETC. In case of single commodity, the underlying commodity could be anything like gold, oil, gasoline, natural gas etc. and in case of Index tracking ETC, total- return index is tracked.

(f) Over- the-counter(OCD) commodities derivatives:

In contrast to an exchange trading, OCD commodity trading occurs directly between two parties and the price is usually not made public. Due to bilateral nature, there are high credit risk concerns.

1.4.2 Debt Market

In the debt market, trading of debt instruments takes place. Debt instruments are in the nature of obligation to repay, and include mortgage, lease, note, bond, certificate etc. Trading of debt instrument helps to transfer debt obligations. Each debt instrument has a maturity period, coupon and principal. Maturity period, also known as the term or tenure, refers to the date on which the debt instrument matures i.e., the date of repayment of the principal. The interest payments made by the borrower to the lender is known as the coupon. The payment is periodic and coupon is usually a rate fixed as a percentage of the par value of the debt instrument. Principal is the amount borrowed or the value of the debt instrument.

Debt instruments are usually classified on the basis of maturity time period and can be – short term debt (debt raised for a period of less than one year), medium term debt (debt raised for a period of two to five years) and long term debt. Short term debt instruments include commercial papers and inter-corporate debt. Medium term debt instruments include public deposits, medium term loan instruments etc. Long term debt instruments include bonds, debentures and term loans. Some of the common debt instruments are the following.

(a) Commercial papers – These are unsecured promissory notes issued on a short term basis.

(b) Inter-corporate Deposits – These are unsecured short term deposits which are mobilized by corporate from other corporate.

(c) Bonds – These are unsecured financial instruments carrying a high interest rate and can be floated with fixed interest rate or floating interest rate. If these are floated with

no interest rate, such bonds are known as discount bonds and are issued at a discount to the face value of the bond.

(d) Debentures – These are fixed interest debt instruments issued for different periods depending upon the need of the issuer.

1.4.3 Equity Market

In equity market, shares are issued and traded. This is done either through exchange or could be over-the-counter. Equity markets play a crucial role in meeting the financial requirements of companies. Equity market can be sub-divided into two major sectors – primary market and secondary market.

Issue of new securities directly by a company to investors to meet monetary requirements takes place in primary market. These new securities are issued by a company either for setting up a new venture or for meeting the expenses of expansion of an existing venture. The primary market operates through public issue, offer for sale, rights issue, bonus issue and issue of Indian Depository Receipt (IDR).

- Public issue comprises of issue of shares of a company to public directly by the company looking to raise money or through some institutional investors. Public issue can either be initial public issue (IPO) and Further Public Issue (FPO). In case of IPOs the shares are issued for subscription by the company for the first time. In order to protect investors, SEBI has come up with a number of guidelines providing for compulsory disclosures by companies floating public issues. These disclosures allow the public to make informed decisions and make companies accountable. FPOs also known as Follow on Issues are issued by companies post IPO to meet further monetary requirements.
- Offer for sale, done thorough issue of offer document and listing of company's shares in the stock exchange, are initiated by institutional investors and not the company itself. Institutional investors invest in unlisted companies in their nascent stage and offer their shares to the public at a later stage when the company has grown. For this purpose, institutional investors look for companies with growth potential to put in their money. Subsequently, they are able to make profit by offering their shares for sale and receiving the proceeds thereof. This always involves greater risk factors and depends on several permutations and combinations by the expert investors.
- Rights issue are issue of shares or other financial instruments by a company to its existing shareholders. In case of rights issue, a company approaches its existing share

holders via letter of Offer. Rights issue usually works for companies who have a proven track record. Usually, the shares are issued to the existing shareholders in proportion to the number of shares already held by them. For example, if a company goes for right issue in the ratio of 1:20, then for every 20 shares held by an existing shareholder, the shareholder has the right to subscribe to one new share. Thus a shareholder holding 100 shares can subscribe to 5 shares under the rights issue.

- Bonus issue is issue of shares by a company to its existing shareholders out of a company's reserves. These are usually in the nature of reward given by a company to its investors for investing in it. Bonus issue, like rights issue, is done in proportion to the number of shares held by a shareholder. This if the ratio determined by the company is 1:10, then for every 10 shares held by an investor, 1 bonus share would be issued.
- Indian Depository Receipts (IDRs) are instruments issued by banks for trading in shares of a foreign company. If a foreign company wants to raise money from Indian market, it would approach a local bank, usually known as the custodian bank to keep its shares in trust. This bank can then issue IDRs, which can be traded on the stock market.

Secondary market is a market where investors purchase securities from each other. Unlike primary markets, companies themselves do not issue these securities. This market operates parallel to the primary market. Issue of IPO by a company takes place on the primary market and subsequently these shares are traded on the secondary market between investors themselves. Another key difference between primary market and secondary market is that while in case of securities traded on primary market, the price of shares or any security floated is predetermined by the issuer company, in case of secondary market, the price at which the security is traded between the investors is determined by supply and demand for the same[1].

1.4.4 Foreign Exchange Market/Currency Market

Trading of decentralized (over-the-counter) international currency takes place over the foreign exchange market. It is the world's largest and most liquid market. It is crucial for determination of relative value of different currencies. Relative value means determination of value of one currency by comparison to another currency. Both the currencies to be compared

[1] While the concept of primary and secondary market are discussed in context of equity market, it is to be understood that both equity and debt instruments are traded in these markets.

are together known as ‘currency pair’. The first currency of a ‘currency pair’ is known as the ‘base currency’ while the second currency is known as the ‘counter currency’. When a currency pair is bought, the base currency is bought and the counter currency is sold. Again, when a currency pair is sold, base currency is sold while the counter currency is bought.
Its main participants are central banks and other large banks, governments, financial institutions, institutional investors, currency speculators and retail investors.

1.5 THE PLAYERS

1.5.1 Brokers

Brokers are commissioned agents working either for the buyer or for the seller on the basis of some commission or charge. They are the point of contact between buyers and sellers of financial products and are sought after due to their knowledge of financial market. Their specialized knowledge is very useful for both the buyers and sellers in maximising their profits. Brokers do not take position in the asset they trade. Consequently, they do not maintain inventories in their assets.

1.5.2 Dealers

Dealers too work for buyers and sellers of financial instruments/assets but are different from brokers in the sense that they do not work for commissions. They are able to “take positions” in the asset in which they trade. Dealers make profit from buying at a low price and selling at a higher price.

1.5.3 Investment Banks

Investment banks play a crucial role in sale of Initial Public Offerings (IPOs). Their main task is to advice the entity releasing the security regarding the terms and conditions, format etc. of the security to be issued. The corporate entities rely on the services of these investment banks also because these banks guarantee a fixed price for the securities offered for subscription and minimum number of subscription. Morgan Stanley and Goldman Sachs are the examples of some renowned investment banks.

These financial institutions help individuals, companies and governments in raising capital. An investment bank acts as the agent of said individual, company or government for issue of securities. Other services provides by such institutions include facilitating mergers and acquisition, derivative trading, foreign exchange, commodity trading, providing fixed income securities and market making. Functions performed by investment banks can also be divided into – ‘Sell sides’ and ‘Buy Sides’. Sell sides refer to trading of securities, which could either be for cash or for other securities. As regards other securities, institutions

engage in underwriting, selling and trading in securities. Buy sides refer to the financial institutions dealing in pension fund, mutual fund and hedge funds.

Investment banks differ from conventional banks in the sense that they do not accept deposits from public or give out loans. They provide non financial services (permitted under the Banking Regulation Act) in the capital market. They are intermediaries engaged in raising capital, facilitating mergers and acquisitions and trading in securities. Such financial institutions advice their client on different financial steps pertaining to the activities mentioned above.

1.5.4 Financial Intermediaries:

These are financial institutions which deal in financial asset transformation. They purchase one kind of financial asset from borrowers and sell a different kind of asset. While brokers and dealers take part in direct buying and selling of securities, financial intermediaries are the site of indirect borrowing and lending. Financial intermediaries have three key advantages. First, the financial intermediaries help in bringing down the transaction cost due to their size. Second, the financial intermediaries help in risk sharing by using diversification (since they are able to acquire different types of financial products from different borrowers). Third, the financial intermediaries have expert knowledge in the field and can act as screening system for bad credit risks.

There are different types of financial intermediaries such as – Depository institutions, Investment Intermediaries and Contractual Savings Institutions.

- Depository institutions accept deposits and advance loans. The deposits which they accept become their liabilities while the loans which they advance are their assets. They include commercial banks, saving banks and loan associations.
- Investment Intermediaries include finance companies and mutual funds (money market and stock and bond). Investment Intermediaries get funds by selling commercial papers, bonds and stock. Funds acquired are used to advance loans. In case of mutual funds, fund is acquired by selling shares to individual investors who are able to lower their transaction cost and get expert knowledge for investment. The fund so acquired is used for buying stocks and other financial instruments.
- Contractual Savings Institutions primarily consist of insurance companies. They get funds on a regular, periodic basis and use these funds to buy corporate bonds, stocks and mortgages.

1.5.5 Merchant Bankers:

Merchant banks are also intermediaries in the capital market which assist their client in raising capital by issue of securities. They offer services relating to management of public offer of securities. Merchant banking differs from investment banking in the sense that investment banking is a much wider term including within its fold various other issues such as the issue and management of securities. They are known as specialised agencies for issue of securities. Need for merchant banking services was felt for the first time with the enactment of the Foreign Exchange Regulation Act 1973, which provided for ceiling on holdings of foreign banks.

SEBI (Merchant Bankers) Regulation 1992 was formulated to streamline the activities pursued by these institutions. Regulation 2(cb) defines a merchant banker as "Any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as managers, consultant, advisor or rendering corporate advisory service in relation to such issue management."

Regulations provide for registration of merchant bankers. Four categories are specified under which merchant bankers can be registered with SEBI. Under category I, merchant bankers are allowed to carry out activity of issue management. This includes prospectus preparation and financial structure determination. Under category II, they can act as advisors, consultants, co-managers, underwriters and portfolio managers. Under category III, they are entitled to act as advisors, consultants and underwriters to an issue. Under category IV, merchant banker can act only as an advisor or consultant to an issue.

The Regulation also prescribes Code of Conduct to be followed by the merchant bankers. Some of the key guidelines to be adhered by the merchant bankers are:-

(a) Merchant bankers are expected at all times to exercise due diligence and be professional in their judgment and conduct.
(b) Investors should be provided with true and adequate information.
(c) Misleading claims of any securities offered can result in action being taken against such merchant banker.
(d) Merchant bankers are to maintain an arms length between merchant banking activity and any other activity simultaneously pursued by them. They are also to avoid any conflict of interest. In case of any conflict of interest, full disclosure should be made of the same at the earliest.
(e) Merchant bankers should not participate in creating false market, rigging or leaking of price sensitive information of securities listed or proposed to be listed.

1.6 INDIAN BANKING SECTOR

1.6.1 Origin of Modern Banking in India

While Indian banking system can be traced right from the vedic period with principles of money lending being laid down by Manu, modern banking can be traced to seventeenth century with the establishment of first joint stock bank in 1786 in the form of General Bank in India. Three Presidency banks, Bank of Bengal, the Bank of Bombay and Bank of Madras are established in 1809, 1840 and 1843 respectively under the charters of British East India Company. They were later amalgamated in 1920 to form the Imperial Bank. Imperial bank, after the nationalization, is renamed as 'State Bank of India'. Allahabad Bank was established in 1865 followed by Punjab National Bank in 1895. Eighteenth century saw a number of banks being established, some of which still exist today. The list includes the Corporation Bank, Canara Bank, Central Bank, Bank of Baroda etc. Reserve Bank was established in 1935 and was bought under the governmental control by virtue of the Banking Regulation Act 1949. The Act entrusted Reserve Bank with the task of supervision and control of other banks in India.

1.6.2 Era of Nationalization

Banks are in control of savings and have a key role to play in the financial system of a country. They are responsible for mobilizing resources and channelling them to other areas as per requirements. Post independence, there were certain key sectors like agriculture, small scale industries and export, which were in need of credit. However, there were complaints that banks were solely catering to the need of big business houses and were neglecting priority sectors. To deal with the problem, it was felt that there should be governmental control over banks so that government could enforce its people centric policies via the banks and credit could be evenly distributed in the society, in pursuance of the socialistic goal of the country.

The rationale behind bank nationalization is reflected in the long title of the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970, which was passed for the purpose of taking over the control of banks by the government. It specifies;

An Act to provide for the Acquisition and Transfer to the undertakings of certain Banking Companies, having regard to their size, resources, coverage and organization, in order to control the heights of the economy and to meet progressively and serve better, the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto.

Fourteen major banks were nationalized on 19 July 1969. These banks were – The Central Bank of India Ltd., The Bank of India Ltd., The Punjab National Bank Ltd., The Bank of Baroda Ltd., The United Commercial Bank Ltd., The Canara Bank Ltd., The United Bank of India Ltd., The Dena Bank Ltd., The Syndicate Bank Ltd., The Union Bank of India Ltd., The Allahabad Bank Ltd., The Indian Bank Ltd., The Bank of Maharashtra Ltd. and the Indian Overseas Bank Ltd. These banks held an aggregate deposit of ₹. 2,632 crores and had 4,130 branches. On 15 April 1980 six more banks were nationalized under the Banking Companies (Acquisition and Transfer of Undertakings) Act 1980. The Act provided that the banks were nationalized for securing the principles laid down in clauses (b) and (c) of Article 39 of the Constitution. Article 39 clause (b) and (c) provide for directive principle of State policy for securing that ownership and control of material resources of community are distributed for sub-serving common good and operation of economic system does not result in concentration of wealth and means of production to the common detriment. The banks nationalized in this phase were- The Andhra Bank Ltd., The Corporation Bank Ltd., The New Bank of India Ltd., The Oriental Bank of Commerce Ltd., The Punjab and Sind Bank Ltd., and The Vijaya Bank Ltd.

Nationalized banks are expected to:

(a) Provide credit to priority sectors such as agriculture, small scale industries, export etc.

(b) Make available banking facilities in rural areas.

(c) Meet reasonable demands of public sector undertakings.

(d) Encourage new enterprises by making available credit at concessional rate.

The Banking Regulation Act 1949 has limited application to nationalized banks. The nationalized banks, unlike other banks are not registered under the Companies Act. They are registered under the Bank Nationalization Act 1970/1980. Moreover under Section 34-A of Nationalization Act, certain banks cannot be compelled to produce books of accounts or documents which are of a confidential nature. Certain provisions of the Banking Regulation Act 1949 are applicable to nationalized banks and these are specifically provided for in the Act. Nationalized banks are regulated as per the Regulations framed by the Board of Directors of the Banks made after consultation with the Reserve Bank and with the previous sanction of the Central government. These Regulations are notified in the official Gazette and have to be in conformity with the provisions of the Nationalization Act.

1.6.3 Entry of Foreign Banks

In 1991, the Committee on the Financial System recommended that Reserve Bank should allow entry of new banks in private sector. In pursuance of the recommendations,

Reserve Bank in 1993 issued guidelines on entry of private sector banks in India. As per the regulations, new banks could be opened with a capital of ₹100 crore, modern technology and head office at a non-metropolitan centre. The paid up capital was subsequently increased to ₹ 200 crore in 2001 and had to be raised to ₹. 300 crore within a period of 3 years from the commencement of business. Post 1993 guidelines, 9 banks in private sector were set up and foreign banks were also allowed to set up subsidiaries, joint ventures or branches.

Foreign banks have the same licensing system as Indian banks. Foreign banks have equal access to the payments and settlement systems and are full members of clearing houses and payments system. This equality of treatment to foreign banks cannot be disturbed due to the WTO commitments of India. Before opening a branch, foreign banks have to apply to the Reserve Bank which is considered by the bank under Section 22 of the Banking Regulation Act 1949. Section 22 of the said Act provides for the licensing procedure. Prior to the grant of a license, the Reserve bank should be satisfied regarding the fulfilment of the following conditions:

(a) Company is or will be in a position to pay its present or future depositors in full as their claims accrue;
(b) Affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interests of its present or future depositors;
(c) General character of proposed management of proposed bank will not be prejudicial to public interest or interest of depositors;
(d) Company has adequate capital structure and earning prospects;
(e) Grant of license will not be prejudicial to the operation and consolidation of the banking system consistent with the monetary stability and economic growth;
(f) Law of the country in which the bank is incorporated does not discriminate against banks from India.

Technical Paper on Differentiated Bank Licenses issued by Reserve Bank highlights India's liberal policy towards foreign banks and lists down three specific instances of fair and equal treatment of foreign banks in India. Firstly, India issues a single class of banking license. There are no limitations on bank operations and bank can carry on both retail and wholesale banking. Secondly, the system of deposit insurance cover is also applicable to foreign banks at a uniform rate of premium. Thirdly, most of the norms applicable to foreign banks, such as norms for capital adequacy, income recognition etc., are same as those applicable to Indian banks.

Reserve Bank issued its policy on opening of branches by foreign banks in its 'Roadmap for

presence of Foreign Banks in India' during a Press Release in 2005. A branch authorisation policy was also issued in 2005. As per the branch authorisation policy, the applicable policy is same as applicable to Indian banks subject to certain conditions such as:

i. Foreign banks have to bring an assigned capital of US $25 million up front at the time of opening of the first branch in India.
ii. Existing foreign banks have to comply with the above mentioned requirement at the time of opening their second branch.
iii. Branch expansion plans have to be submitted on an annual basis.
iv. The foreign bank and its group's track record will be considered before granting permission.
v. Treatment provided to Indian banks in home country of applicant foreign bank will be considered as well as consideration will be given to bilateral and diplomatic relations between India and the home country.

1.7 SUMMARY

Financial sector denotes the complex setup formed by all the interrelated parties, institutions, and regulators etc. which have a part or are closely connected with the system providing the connecting link between the investors and the consumers or savers. Indian financial sector comprises of the regulatory bodies which includes the Reserve Bank of India, Securities and Exchange Board of India, Forward Markets Commission, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority , Ministry of Finance; markets (commodities, equity, debt, foreign exchange) and the different players in it (brokers, firms, banks, financial institutions, foreign institutional investors, mutual fund managers, investors, exchanges, depositories, custodians, registrars).

India has a rich banking history but the origins of modern banking can be traced to the seventeenth century. A number of banks were established in the eighteenth century some of which are still in existence now. A watershed in the history of Indian banking is bank nationalization in and after 1969. Governmental control over banks was felt necessary for securing the principles laid down in clauses (b) and (c) of Article 39 of the Constitution. Post 1991, Indian economy was opened and in 1993, acting upon the suggestions of the Committee on the Financial System, Reserve Bank allowed entry of foreign banks in India. India follows a very liberal approach towards foreign banks and treats them almost at par with the Indian banks.

1.8 KEYWORDS

1. Financial Sector
2. Regulators
3. Reserve Bank of India
4. Forward Markets Commission
5. Securities and Exchange Board of India
6. Ministry of Finance
7. Insurance Regulatory and Development Authority
8. Pension Fund Regulatory and Development Authority
9. Markets
10. Commodity Market
11. Debt Market
12. Equity Market
13. Foreign Exchange Market
14. Players
15. Brokers
16. Dealers
17. Investment Banks
18. Financial Intermediaries
19. Modern Banking
20. Nationalization
21. Foreign Banks

1.9 SELF ASSESSMENT QUESTIONS

1. Define financial sector? Highlight the different components of Indian financial sector?

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2. What is the role of Reserve Bank of India in Indian financial system?

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3. What do you mean by financial markets? Elaborate on the different kinds of markets.

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4. Who are the key players in the financial sector? Discuss their functions.

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5. What are financial intermediaries? Name the different kinds of financial intermediaries?

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6. Point out the chief arguments in favour of bank nationalization. What are the special tasks of the nationalized banks?

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7. What is India's policy towards entry to foreign banks in India? Do you feel that Indian banks are given a better deal in comparison to foreign banks?

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UNIT- 2: COMMERCIAL BANKS AND THEIR FUNCTIONS

Structure:

2.0 Objectives

2.1 Introduction

2.2 Early banks in india

2.3 Structure of banking system

2.4 Commercial banks

2.5 Main functions of commercial banks

2.6 Summary

2.7 Keywords

2.8 Self Assessment Questions

2.9 References

2.0 OBJECTIVES

- To able Understand the meaning of –bank, banking, banking system.
- To analyse the gaining insight into the development of early banking system in India.
- To understand the meaning and functions of commercial banks.

2.1 INTRODUCTION

According to a prevalent view, the word 'Bank' owes its origin to the French word 'bancus' or the Italian word 'banco' both of which meant bench. Others opine that the word 'Bank' originated from the German word 'back' which means a joint- stock fund[2]. Whatever be its origin, a bank is primarily understood to be a financial institution engaged in providing banking and non-banking facilities.

The Banking Regulation Act 1949, under Section 5(b), defines 'Banking' as "accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise." Further, 'Banking Company' has been defined under Section 5(c) as "a company which transacts the business of Banking in India." However, the modern day banks have expanded their functions to include some aspects that were unknown to the traditional system of banking. They have become integral part of the society and welfare state. The strength of State economy is also dependant on the banking system, which is well demonstrated by the shattering of the United State's economy due to the collapse of its major banks.

2.2 EARLY BANKS IN INDIA

General bank of India was the first bank established in India in 1786. This was followed by establishment of three Presidency Banks in Calcutta, Bombay and Madras respectively by the East India Company. These banks were subsequently amalgamated to form the Imperial Bank of India in the year 1921. Post establishment of Presidency Banks, Bank of Hindustan was established in the year 1870. The late nineteenth century and early twentieth century saw the establishment of a number of banks, major among them being, Punjab National Bank Ltd., Central Bank of India, bank of Baroda, Canara bank, Bank of Mysore, Reserve Bank of India (1935) etc.

Major legislation came in the year 1949 with the Government of India enacting the Banking Regulation Act 1949. Section 6 of the Banking Regulation Act 1949 provides for the businesses in which banking companies may engage themselves. These include:

[2] According to Tannan, the word came to be used from the practice of use of benches by Jewish money changers of Lombardy, a district in North Italy. On failure of the Banker to transact his business, his bench was symbolically broken up by the people.

(a) Banking Business
(b) Borrowing, raising or taking up of money
(c) Lending or advancing of money
(d) Drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hondes, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities
(e) Granting and issuing of letters of credit, traveller's cheques and circular notes
(f) Selling and dealing in bullion and specie
(g) Buying and selling of foreign exchange
(h) Acquiring, holding, issuing on commission, underwriting and dealing in stocks, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments
(i) Providing safe deposit vaults
(j) Carrying on agency business including clearing and forwarding of goods, giving of receipts and discharges and acting as attorney on behalf of customers
(k) Transacting and carrying on guarantee and indemnity business
(l) Contracting, negotiating and issuing public and private loan
(m) Undertaking and executing trusts
(n) Undertaking administration of estates as executor, trustee or otherwise

Another major development was nationalization of Imperial Bank of India in 1955. It was named as "State Bank of India" under the State Bank of India Act 1955. Post this a period of bank nationalisation followed, a process in place till late 1970s. Early 90s saw India opting for opening up of the banking sector and in 1993 the Banking Regulation Act was amended for the purpose.

2.3 STRUCTURE OF BANKING SYSTEM

If we look at the structure of banking system in India, we find that the system comprises of the following institutions:

(a) The Reserve Bank of India
(b) The Commercial Banks
(c) The State Bank of India
(d) The Co-operative Banks
(e) The Foreign Banks
(f) Rural Banks
(g) Land Mortgage Banks

(h) Nationalized Banks

(i) Industrial Finance Corporations

(j) State Finance Corporations

(k) Industrial Investment and Credit Corporation

(l) Re-Finance Corporation

(m) Industrial Development Bank of India

(n) Unit Trust of India

(o) Industrial Reconstruction Corporation of India

(p) Credit Guarantee Corporation of India

(q) Agricultural Refinance Corporation

(r) Export Credit and Guarantee Corporation

(s) Deposit Insurance Corporation

2.4 COMMERCIAL BANKS

Commercial banks are financial institutions that provide services, such as accepting deposits, giving business loans and auto loans, mortgage lending, and basic investment products like savings accounts and certificates of deposit. In India, Commercial Banks refer to both scheduled and non-scheduled commercial banks which are regulated under Banking Regulation Act 1949. Scheduled Banks are those banks that have been included in Second Schedule of the RBI Act 1934. These banks have to fulfil several criteria such as paid-up capital, reserves, total value and certification by RBI. Non-Scheduled Banks are those that are not included in the list of Scheduled Banks. They have to follow the Cash Reserve Ratio (CRR) condition.

Scheduled Commercial Banks are grouped under the following categories:

(a) State Bank of India and its Associates – State Bank of India has five associate banks in the form of State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore.

(b) Nationalised Banks – The different nationalized banks are Allahabad Bank, Punjab National Bank, Andhra Bank, Reserve Bank of India, Bank of Baroda, State Bank of Bikaner & Jaipur, Bank of India, State Bank of Hyderabad, Bank of Maharashtra, State Bank of India, Canara Bank, State Bank of Mysore, Central Bank of India, State Bank of Patiala, Corporation Bank, State Bank of Travancore, Dena Bank, Syndicate Bank, Indian Bank, UCO Bank, Indian Overseas Bank, Union Bank of India, Oriental Bank of Commerce, United Bank of India, Punjab & Sind Bank and Vijaya Bank.

(c) Foreign Banks- The different foreign banks in India as on 31 March 2013 are the following.

- AB Bank Ltd. (Bangladesh)
- The Royal Bank of Scotland N.V. (Netherlands)
- Abu Dhabi Commercial Bank Ltd. (UAE)
- American Express Banking Corporation (USA)
- Antwerp Diamond Bank N.V. (Belgium)
- Bank International Indonesia (Indonesia)
- Bank of America (USA)
- Bank of Bahrain & Kuwait BSC (Bahrain)
- Bank of Ceylon (Sri Lanka)
- Bank of Nova Scotia (Canada)
- Barclays Bank Plc. (United Kingdom)
- BNP Paribas (France)
- Credit Agricole Corporate & Investment Bank (France)
- Chinatrust Commercial Bank (Taiwan)
- Citibank N.A. (USA)
- DBS Bank Ltd. (Singapore)
- Deutsche Bank (Germany)
- HSBC Ltd (Hong Kong)
- J.P. Morgan Chase Bank N.A. (USA)
- JSC VTB Bank (Russia)
- Krung Thai Bank Public Co. Ltd. (Thailand)
- Mashreq Bank PSC (UAE)
- Mizuho Corporate Bank Ltd. (Japan)
- Oman International Bank SAOG (Sultanate of Oman)
- Shinhan Bank (South Korea)
- Societe Generale (France)
- Sonali Bank Ltd. (Bangladesh)
- Standard Chartered Bank (United Kingdom)
- State Bank of Mauritius (Mauritius)
- The Bank of Tokyo- Mitsubishi UFJ Ltd. (Japan)
- UBS AG (Switzerland)
- FirstRand Bank Ltd (South Africa)

- United Overseas Bank Ltd (Singapore)
- Commonwealth Bank of Australia (Australia)
- Sberbank (Russia)
- Credit Suisse A.G (Switzerland)
- Australia and New Zealand Banking Group Ltd. (Australia)
- Rabobank International (Netherlands)
- Industrial & Commercial Bank of China Ltd. (China)
- Woori Bank (South Korea)
- National Australia Bank (Australia)
- Westpac Banking Corporation (Australia)
- Sumitomo Mitsui Banking Corporation

(d) Regional Rural Banks – Regional Rural Banks (RRBs) were established under Regional Rural Banks Act 1976 (the RRB Act) to cater to the financial needs of the rural and agriculture sector. RRBs are jointly owned by the Government of India, the concerned State government and sponsor banks, with the issued capital shared in the proportion of 50 percent, 15 percent and 35 percent, respectively. The authorized capital of each RRB is ₹ 5 crore and the issued capital is a maximum ₹ 1 crore.

At present 82 Regional Rural Banks are operating in India. Some of the prominent ones are the following.

- Allahabad UP Gramin Bank (Allahabad Bank)
- Andhra Pradesh Grameena Vikas Bank (State Bank of India)
- Andhra Pragathi Grameena Bank (Syndicate Bank)
- Arunachal Pradesh Rural Bank (State Bank of India)
- Aryavart Gramin Bank (Bank of India)
- Assam Gramin Vikash Bank (United Bank of India)
- Baitanri Gramya Bank (Bank of India)
- Ballia Etawah Gramin Bank (Central Bank of India)
- Bangiya Gramin Vikash Bank (United Bank of India)
- Baroda Gujarat Gramin Bank (Bank of Baroda)
- Baroda Rajasthan Gramin Bank (Bank of Baroda)
- Baroda UP Gramin Bank (Bank of Baroda)
- Bihar Kshetriya Gramin Bank (UCO Bank)
- Cauvery Kalpatharu Grameena Bank State (Bank of Mysore)
- Chaitanya Godavari Grameena Bank (Andhra Bank)

- Chhatisgarh Gramin Bank (State Bank of India)
- Chikmagalur Kodagu Grameena Bank (Corporation Bank)
- Deecan Grameena Bank (State Bank of Hyderabad)
- Dena Gujarat Gramin Bank (Dena Bank)
- Durg Rajnandgaon Gramin Bank (Dena Bank)

(e) Other Scheduled Commercial Banks (Private Banks) – These are ING Vysya Bank Ltd., Axis Bank Ltd., Indusind Bank Ltd., ICICI Bank Ltd., South Indian Bank, HDFC Bank Ltd., Centurion Bank Ltd., Bank of Punjab Ltd., IDBI Bank Ltd. and Jammu & Kashmir Bank Ltd.

2.5 MAIN FUNCTIONS OF COMMERCIAL BANKS

The main functions of commercial Banks are:

(a) Receiving Deposit from Public:

Commercial Banks are the custodian of people's deposits and it constitutes one of the most important functions of commercial Banks. Banks are seen as a place for safe keeping of cash money. The Banks while accepting deposits undertake the liability to repay money and provide a host of services relating to it. The deposits received by the Bank are used for a variety of purposes and the strength of a Bank depends upon the deposit it receives from its customers. Depending upon the nature of deposits, deposits can be demand deposits, saving deposits or fixed deposits. Demand deposits can be withdrawn by depositor at any time. They are also known as current accounts and can be created either by the depositor converting his cash into demand deposit or by borrowing an amount from the Bank and using it to create a demand deposit. They are useful for businessmen and are usually devoid of interests. Saving deposits are also on demand deposits; however they earn interest for the depositors. Fixed deposits are those where money is locked for a specified period. Usually the rate of interest available on these deposits is higher than that available on saving deposits.

(b) Making of Loans and Advances:

Commercial Banks provide loans and advances for profits out of the deposits received from the public. The loans or the advances provided by the banks are subject to interest, which is used by the banks to meet their administrative expenses. There are various methods of lending. One of the most common ways of lending is by allowing the borrower to overdraw his current account. Banks usually have a set of criteria to determine persons entitled to be given loans. These loans given by Banks are generally secured against some movable or immovable assets. Loan facility helps in the development of trade and commerce and persons who wish to carry on business or expand the business. The bank financing is

useful for those entrepreneurs who are hit by capital issues. Recent trends in the commercial financing show that the banks heavily rely on the cash-flow of the companies for granting loans.

(c) Transfer of funds:

Commercial Banks transfer money from one place to another. Transfer of money can be done by drawing of drafts upon braches or agents of Banks, bill of exchange or electronically. Though the traditional drafts and bill of exchanging are losing significance in the electronic era, a large portion of Indian population still repose trust on these traditional means of money transfer. The modern day electronic services are so fast that huge amount of money can be transferred to great distances in fraction of a second. This has been a boon for commercial entities, especially the multinational enterprises. Banks usually charge a small fee for these kinds of services.

(d) Cheque System:

Commercial Banks are responsible for developing the cheque system, which allows depositor an easy and convenient mode of withdrawal of money. Prior to development of the cheque system, Banks used to issue notes. However, Bank notes have lost their popularity and cheque currency is the preferred mode of payment, especially where large sums are involved. Cheque system is gradually being replaced by plastic cards known as debit cards, which can be used to withdraw money via automated teller machines (ATMs). These cards have fastened the process of withdrawal by the depositors by avoiding the time period required for waiting in the queue at different banks.

(e) Agency Functions:

Commercial banks perform a number of agency functions such as providing safety locker, providing facility of money transfer, issuing traveller's cheque, accepting various bills for payment, providing merchant banking facility and providing debit card and credit card. Both the debit and credit cards are useful for people in making payments during commercial transactions. Undoubtedly, they are advantageous, since the users need not take the risk of carrying cash for payment.

(f) Providing various financial services:

Commercial banks provide various financial services such as insurance related service, wealth management service and investment banking. The banking sector has broken the monopoly of the Life Insurance Corporation of India in providing insurance coverage for wide variety of risks. The wealth management services provided by the banks include the referral services, investment advisory services and portfolio management services. The

investment banking services of the banks are directed towards the creation of capital for the corporate companies. The range of services provided by the investment banks include underwriting and sale of securities, facilitating mergers and acquisitions, assisting in corporate reorganization, acting as brokers for both individuals and institutions etc. In addition to these financial services, banks also perform the task of providing the foreign exchange. While the above-mentioned manifold functions are performed by the banks, not all the bank offices or their branches perform all the functions. In light of this factor, the RBI has developed a unique coding system indicating the functions of the bank offices or branches. Following chart demonstrates the bank office and branch coding system.

Code	Description
0	Only Banking Business
1	Banking and Foreign Exchange Business
2	Administration, Banking and Foreign Exchange Business
3	Administration and Banking Business
4	Administration & Foreign Exchange Business
5	Only Foreign Exchange Business
6	Only Administration / Training / etc.
7	Non-Scheduled Banks doing Banking Business

2.6 SUMMARY

Bank is a financial institution engaged in the business of providing banking and non-banking functions. In India, the first modern bank was established in 1786, followed by the establishment of three Presidency banks under the charter of East India Company. A major change in the Indian banking sector came with the enactment of the Reserve Bank of India Act 1934 and the Banking Regulation Act 1949 under which Reserve bank was established as the central bank of India and put under the governmental control. The Indian banking system has a complex structure with a very vital role being played by commercial banks. Commercial banks are financial institutions providing various services such as accepting deposits, giving loans, mortgage lending and basic investment products such as savings accounts and certificate of deposit. Scheduled commercial banks are further grouped under different categories – State Bank of India and its Associates, Nationalized Banks, Foreign Banks, Regional Rural Banks and Private Banks. The banks perform variety of functions ranging from collection of deposits and granting loans to agency and other related functions.

2.7 KEYWORDS

1. Bank
2. Banking
3. Presidency Banks
4. Structure of Banking System
5. Commercial Banks
6. Nationalized Banks
7. Foreign Banks
8. Regional Rural Banks
9. Deposit
10. Loan
11. Cheque
12. Agency

2.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by the term 'bank' and 'banking'? Describe the kind of business in which the banking companies can engage.

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2. Enlist the various institutions existing in the Indian banking system.

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3. What are commercial banks? Mention their different functions.

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4. Name the different types of scheduled commercial banks.

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UNIT- 3: BANKING AS A BUSINESS OF BORROWING AND LENDING

Structure

3.0 Objectives

3.1 Introductions

3.2 Banking as a business of borrowing and lending

3.3 Balancing between profitability and liquidity

3.4 The banker's obligation of honouring the demand of customer

3.5 Summary

3.6 Keywords

3.7Self Assessment Questions

3.8 References

3.0 OBJECTIVES

- To understand the banking as a business of borrowing and lending.
- To highlighting the need for banks to balance between profitability and liquidity.
- To appreciating banker's obligation of honouring legitimate demands of customers and nature of relationship between banker and customer.

3.1 INTRODUCTION

One of the primary functions of banks is to extend credit, and for this, banks depend upon deposits. This makes it necessary for the banks to put in their best efforts at mobilizing deposits. The Reserve Bank of India has laid down a number of rules, policies and guidelines highlighting the way in which banks should go about their business of accepting deposits and then subsequently lending it for making profits. This also requires a balancing act on the part of the banker, since on the one hand, the banker is obliged to honour the customers' demand and on the other hand, the banker is also obliged to run the bank for profits. The former requires the banker to maintain adequate liquidity for meeting the customers' demands and the latter necessitates the lending of deposits lying with bank at higher rate of interest and earning profits. Past events have shown that it is very crucial to do this balancing act properly, as several recent financial crises owe their origin in the maintenance of inadequate liquidity. Thus the banker's success rests in the striking of delicate balance between the elements of borrowing and lending.

3.2 BANKING AS A BUSINESS OF BOROWING AND LENDING

One of the primary functions of banks is to extend credit. The borrowers belong to different categories and loans are sought for a variety of purposes. Depending upon the bank policy and the RBI guidelines, banks take decision on advancing loans to individuals, corporate entities, government undertakings, traders etc. Banks are vital for supplying the credit requirements and banking business primarily comprises of this system of borrowing and lending. Some of the important policies and principles of borrowing and lending are discussed hereunder:

(a) Banks depend on deposits from public to carry on the business of lending. It is very vital for a bank to have deposits which it can advance in the form of loans at a higher rate of interest than that paid upon deposits to earn a profit. For this purpose, banks devote a substantial amount of their effort at mobilizing deposits, encouraging people and other business entities to keep their money with them. A number of schemes with attractive interest rates and special facilities catering to target groups are floated by

banks at regular interval to tap the savings of depositors. For example, bank may come up with special scheme for women, senior citizen, agriculturists and so on.

(b) Bank lending can either be fund based such as overdraft, demand loans, car loans, consumer loans, educational loans, personal loans, housing loans, credit cards, cash credits etc or non-fund based such as issue of guarantees, letter of credit and deferred payment guarantee. While fund based lending are subject to interest, the non-fund based lending are made available for a fee.

(c) While banks want to earn profit by advancing loans, it is necessary that the borrower's credentials are thoroughly verified to minimise chances of default on the part of borrower. For this purpose, banks insist upon checking the creditworthiness of the borrower or upon collaterals as security for loans granted. Security can either be primary such as pledge, hypothecation etc. or secondary such as third party guarantee, charge on immovable property etc. The forms and modes of security have undergone a sea change and presently besides the traditional modes of security available such as mortgage, pledge, bank guarantee etc., new securities such as pledge of shares in DEMAT form are also accepted by the banks. The bank has to ensure that the security provided is sound and free from encumbrances. In case of securities, banks insist upon proper documentation such as proper stamps, proper documents, proper execution etc.

(d) While advancing loans, banks are careful about the loan period to ensure enough liquidity at all times. Usually a bank grants different loans for different periods so that bank has a steady monetary flow. It is also necessary to maintain liquidity as the banker has a legal duty to pay on demand the depositors. Hence, the banker has to keep a certain portion of its total deposits available with him at all times. This is also known as the Credit Deposit Ratio. Credit Deposit Ratio is also guided by the Cash Reserve Ratio deposits and the Statutory Liquidity Ratio. The present Credit Deposit Ratio for the banking sector is around 70 per cent.

(e) Banks also lend to borrowers belonging to different category/groups to diversify their risks. For example, if there is a drought, there are high chances of default by farmers to whom loans might have been granted but the drought would not affect loans granted to students. Thus banks ensure that the category of borrowers is wide to minimise risks. The different categories of borrowers include individuals, companies (public limited and private limited), public sector undertakings, partnership firms and sole proprietors.

(f) Each bank has its own credit policy which is approved by its Board of Directors. This policy is influenced by RBI directives issued from time to time. Usually RBI announces its credit policy in April every year. RBI outlines the priority sectors to which loans must be granted by banks such as agriculture, exporters, SSI among others. These directions have to be incorporated in the bank policy, which usually contains provisions on asset concentration, portfolio management, credit approving authorities, credit-deposit ratio, loan pricing, collateral security, loan pricing, rating standards and provisions on bad debts.

(g) Banks have to be vigilant about the purpose of the loan and identification of the borrower. For this purpose, banks usually insist upon detailed documentation and consider these before deciding on the grant of loan. To identify the borrower, educational or professional qualification of the borrower, the type of organization with which the borrower is associated, past credit performance of the borrower etc. are the relevant factors considered by banks. In case of individuals, banks look into the status of individual (whether major or minor) and insist upon documents such as salary slip, no dues certificate, proof of residence, signature proof, electricity bills etc. In case of commercial entities banks ask for different documents depending upon the type of entity. Some of the key documents checked are income tax statements, business accounts, partnership deeds (in case of partnership), sales tax assessment, registered trust deeds (for trust A/C), certificate of incorporation (for companies), memorandum of association (to see whether the loan is taken in advancement of the legal objectives of the company), certificate of commencement of business, share-holding pattern and list of directors. To gauge the strength of the borrower, bank is guided by 3 Cs- Character, Capacity and Creditworthiness of the borrower. Banks have to look into whether the purpose of the loan is productive, and if loan is sought for some new ventures, bank would look into the business plan and chances of their success. Banks also look into the legitimate nature of activity for which funds are sought and would not grant loans for illegal activities. The loan amount is another determinant while deciding on the grant of a loan. Banks desist from both over-financing and under-financing. Further, usually most loans would have timely dispersal of funds and terms and conditions would be imposed for dispersal.

(h) Banks price their loans differently for different groups. Loan pricing is dependent upon the risk associated with each group. In case there are higher risks associated, a higher rate of interest is charged. Usually banks keep the option of revising the rate of

interest upon loans (floating rates). The cost of loan is dependent upon a number of factors which include cost of raising the loan amount, administrative costs, percentage of bad debt, cost of maintaining Cash Reserve Ratio and Statutory Liquidity Ratio, competition in the sector etc.

(i) Banks usually comply with the BASEL norms. These norms have been prescribed by the Basel Committee for Bank Supervision (BCBS) under which there are certain capital requirements to be followed by all banks. Banks also try to keep in mind the Capital Adequacy Norms (CAR)/ Capital Risk weighted Assets Ratio. As per the recommendations of the Basel Committee, banks should have a CAR of at least 8 per cent. RBI prescribes a CAR of minimum 9 per cent.

(j) Banks have been recommended by RBI to follow a fair practices code for bank loans. It provides that the loan application should include information such as fees/charge payable for loan processing, prepayment options and all other relevant information relating to loans. These practices are directed towards transparency in bank financing by avoiding the element of consumer fraud through the imposition of some hidden charges or other conditions.

(k) Credit Information Companies (Regulation) Act has been passed in 2005, under which every credit institution, including a bank, has to provide such credit information as may be required of it. Credit information bureaus have been established which contain information about the credit history of borrowers. Credit information bureaus collect credit data and create credit reports, which are distributed to its members. This report is known as the Credit Information Report (CIR).

(l) Differential Rate of Interest Scheme (DRI) has been introduced by the Government of India from 1972 onwards, which provides for extending financial assistance at concessional rate of interest at 4% to low income groups. For availing benefit of this scheme, maximum family incomes are determined by the RBI from time to time. Presently, borrowers with annual family income of Rs.18,000 in rural areas and Rs.24,000 in urban and semi-urban areas are eligible. This welfare scheme is very popular in the rural areas, supporting a large group of population depending on agriculture and rural labour.

(m) RBI has also come up with a number of guidelines on corporate debt restructuring. This is applicable when the borrower is unable to repay the loan. In such cases bank can change the repayment or interest payment schedule to improve recovery. It can even waive interest for better chances of recovery. As per RBI guidelines, a fully

secured standard/ sub-standard/ doubtful loan can be restructured by rescheduling of principal repayments and/or the interest element. RBI has formed a Corporate Debt Restructuring (CDR) system to ensure a transparent mechanism for restructuring of corporate debts.

(n) RBI denotes certain sectors to be eligible for priority sector lending to ensure that adequate credit is available to certain sectors of the economy. These sectors include agriculture, small scale enterprises, retail trade, etc. As per RBI guidelines at least 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure (CEOBSE), whichever is higher should be lent to priority sectors. There are also sub-limits for certain sub-sectors within the priority sector such as agriculture.

(o) In case of non-payment of loan, banks have the right to approach the Debt Recovery Tribunals (DRTs) established under the Recovery of Debts due to Banks and Financial Institutions Act 1993 for expeditious recovery of debts owed to banks and financial institutions. It provides that for exercise of jurisdiction by the tribunals, the amount of loan must be of ₹ 10 lakhs and above. Banks can also resort to OTS schemes (one Time payment Scheme) and Lok Adalats for smaller loans.

3.3 BALANCING BETWEEN PROFITABILITY AND LIQUIDITY

Liquidity refers to the ability to obtain cash or have cash to meet financial obligations. This includes the cash reserves and assets which can be easily transferred into cash. Liquidity can be of various types.

(a) **Market liquidity** refers to how readily one can buy or sell a financial asset at short notice, at low cost and large quantity, without causing a significant movement in its price.

(b) **Balance sheet liquidity** refers broadly to the cash-like assets on the balance sheet of a firm or a household. Usually, the items on the asset side of a bank's balance sheet are listed in order of liquidity. The bank's cash reserves are listed upper most and depending on the ease with which a bank's asset can be converted, its different assets are listed in its balance- sheet.

(c) **Funding liquidity** may be defined as the ability of banks to settle obligations with immediacy.

According the Reserve Bank's guidelines on Liquidity Risk management by banks, liquidity 'is a bank's capacity to fund increase in assets and meet both expected and

unexpected cash and collateral obligations at reasonable cost and without incurring unacceptable losses. Liquidity risk is the inability of a bank to meet such obligations as they become due, without adversely affecting the bank's financial condition.' Profitability is a measure of the amount by which a firm's revenues exceeds its relevant expenses.

The primary motive of banks is to earn profit and for this purpose banks look for potential borrowers to whom they can lend money and earn interest. The money lent is again collected from the depositors who are given a lesser rate of interest than at which the money is lent. Depositors are given the facility of being able to withdraw their money according to their convenience to increase deposits. This again requires that the bank have enough liquid assets to meet depositors' demand as and when it arises. Other than the depositors' demand, bank also has a number of other financial obligations on a day to day basis requiring banks to have adequate liquidity. Cash is the most liquid asset but if banks keep a substantial amount of their assets in cash, they are unable to make any profit upon it. Liquid assets (cash and government securities) have a low return rate. So they are not very profitable for banks. This lands banks in a position where they are required to keep their assets liquid which is not profitable for them and for making profits banks have to lend money but that decreases a bank's liquidity. Banks are then obliged to do a balancing act between maintaining adequate liquidity and earning profits.

The bank may go bankrupt if it has adequate liquidity but it is not profitable. Again, it is possible for a bank to go bankrupt if it is profitable but suffers from liquidity crunch because it won't be able to fulfil its present obligations. Both the situations- high liquidity and low profitability and low liquidity and high profitability - are dangerous for the bank. Lack of adequate liquidity has been reflected in the recent global crisis wherein one of the chief reasons for the recent global crisis was lack of liquidity of banks as banks were unable to meet their obligations compelling governments to provide bailout packages. One of the key regulations imposed was aimed at ensuring that banks kept enough liquid assets to meet their obligations even if funding sources disappear.

A number of financial tools are available to measure the bank's liquidity and its profitability to ensure that the ratio does not get distorted and corrections are made whenever necessary. The Reserve Bank's guidelines on Liquidity Risk management list down two major liquidity risks to the banks. They are:

(a) Funding Liquidity Risk- The risk is that a bank may not be able to meet its expected and unexpected current and future cash flows and collateral needs without affecting its daily operations or its financial conditions.

(b) Market Liquidity Risk- The risk that a bank will not be able to eliminate or offset a position at the prevailing market rate.

The guidelines lay down thirteen fundamental principles for management and supervision of liquidity risk. These are:

- Principle 1- Bank should establish a risk management framework to maintain sufficient liquidity.
- Principle 2- Bank should have a clear liquidity risk tolerance appropriate to its business strategy.
- Principle 3- Strategies, policies and practices to manage liquidity risk should be developed by senior management in accordance with risk tolerance.
- Principle 4- Liquidity coasts, benefits and risks should be incorporated in internal pricing, performance management and new product approval process for all significant business activities.
- Principle 5- Bank should adopt a sound process for identifying, measuring, monitoring and controlling liquidity risk.
- Principle 6- Bank should keep a watch on liquidity risk exposures and funding needs, taking into account legal, regulatory and operational limitations to transferability of liquidity.
- Principle 7- Bank should adopt a funding strategy which has diversification in sources and tenor of funding.
- Principle 8- Intraday positions and payment and settlement obligations of a bank should be actively managed.
- Principle 9- The bank's collateral positions should be properly managed.
- Principle 10- Stress test should be conducted on a regular basis to locate sources of potential liquidity strain.
- Principle 11- Bank should have a formal contingency plan (CFP). The CFP should clearly provide for the methods of addressing liquidity shortfalls in emergency situations.
- Principle 12- Bank should have a cushion of unencumbered, high quality liquid assets as insurance against liquidity stress scenarios.
- Principle 13- Market participants should be informed on a regular basis about the bank's liquidity position and its liquidity risk management framework.

3.4 THE BANKERS OBLIGATION OF HONOURING THE DEMAND OF CUSTOMER

The Banking Regulations Act 1949 does not define the term ‘banker’ but defines banking. Section 5(b) states, “Banking means accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise.” We find the term ‘banker’ defined under Section 3 of the Indian Negotiable Instruments Act 1881, which defines the banker to include “any person acting as banker and any post office savings bank”. Again, Section 2 of the Bill of Exchange Act 1882, defines ‘banker’ to include “a body of persons, whether incorporated or not who carry on the business of banking”

The word ‘customer’ too is not defined under the Banking Regulation Act 1949. The Know Your Customer (KYC) Policy defines a customer as:

- A person or entity that maintains an account and/or has a business relationship with the bank;
- One on whose behalf the account is maintained (i.e. the beneficial owner). [Ref: Government of India Notification dated 12 February 2010 - Rule 9, sub-rule (1A) of PMLA Rules – ‘Beneficial Owner’ means the natural person who ultimately owns or controls a client and or the person on whose behalf a transaction is being conducted, and includes a person who exercise ultimate effective control over a juridical person]
- Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- Any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

One of the primary functions of banks as previously discussed is to accept deposits. Banks provide an interest over these deposits giving an incentive to the depositors to deposit their money with them. While accepting the deposits, the banks impose upon themselves an obligation to return the deposit as and when demanded by the depositor subject to the fulfilment of legal requirements. This demand can be either through withdrawable form, cheque, order or other accepted means. As part of this obligation of the bank to honour the customers demand, Section 31 of the Negotiable instruments Act 1881 provides that “The drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment, must compensate the drawer for any loss or damage caused by such

default." Thus, if the customer has sufficient funds in his account and the cheque is presented within the working hours of business, subject to fulfilment of other conditions, bank is under an obligation to honour the customer's cheque. This makes the relationship between the bank and the depositor that of debtor and creditor. The bank is the debtor while the depositor is the creditor. The debtor has to return the money when demanded by the creditor. For this purpose, as discussed above, banks have to ensure adequate liquidity. While the deposit is with the bank, the bank is free to use the deposit. Usually, banks lend the deposits at a higher rate of interest earning profit.

3.5 SUMMARY

One of the primary functions of banks is to extend credit. The borrowers belong to different categories and loans are sought for a variety of purposes. Depending on the bank policy and the RBI guidelines, banks take decision on advancing loans to individuals, corporate, government undertakings, traders etc. Liquidity refers to the ability to obtain cash or have cash to meet financial obligations. This includes the cash reserves and assets, which can be easily transferred into cash. Profitability is a measure of the amount by which a firm's revenues exceeds its relevant expenses. Banks are obliged to do a balancing act between maintaining adequate liquidity and earning profits.

Bank is under an obligation to honour the customer's demand. This makes the relationship between the bank and the depositor that of debtor and creditor. The bank is the debtor while the depositor is the creditor. The debtor has to return the money when demanded by the creditor. For this purpose banks have to ensure adequate liquidity. While the deposit is with the bank, the bank is free to use the deposit.

3.6 KEYWORDS

1. Borrowing
2. Lending
3. Credit Policy
4. Creditworthiness
5. BASEL Norms
6. DRI
7. Profitability
8. Liquidity
9. Liquidity Risk Management
10. Demand

11. Customer
12. Banker
13. KYC Policy.

3.7 SELF ASSESSMENT QUESTIONS

1. What is the role of bank in supplying the credit requirement of a financial system?

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2. Mention the important policies and principles, which must be kept in mind by banks while transacting the business of borrowing and lending?

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3. What is the purpose of introduction of the Differential Rate of Interest Scheme (DRI)?

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4. Why is it necessary for banks to balance between profitability and liquidity? Discuss the Reserve Bank's guidelines on liquidity risk management.

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5. What are the different types of liquidity?

....

....

6. Elaborate on the bankers' obligation of honouring the demand of customer.

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UNIT- 4: BANKER AS BORROWER

Structure

4.0 Objectives

4.1 Introductions

4.2 Time deposit and demand deposit

4.2.1. Meaning of the term ‘deposit’

4.2.2. Types of deposit account

4.2.3. Regulation of deposits by reserve bank

4.2.4. Safety of bank deposits

4.3 Summary

4.5 Keywords

4.4 Self Assessment Questions

4.6. References

4.0 OBJECTIVES

- To understanding the different facets of banker customer relationship.
- To know the meaning and concept of Time Deposits and Demand Deposits.
- To appreciating the role of Reserve Bank in the regulation of deposits.
- To highlighting the role of Deposit Insurance and Credit Guarantee Corporation.

4.1 INTRODUCTION

The relationship between a banker and customer has many facets. Primarily, the relationship between a banker and customer is of debtor and creditor where the banker is a debtor to the customer. The deposits of the customer are in the nature of credit and the banker is under an obligation to honour the demand for return of a customer's deposit. In this sense, banker is a borrower and the customer is the lender. Other than that, banker acts a trustee by keeping a customer's valuable assets in lockers and safe vaults. Banker also acts as an agent of his customer when he collects cheques, drafts or purchases securities on behalf of the customer. Besides these, banker can also act as a bailee by keeping valuables and documents of the customer.

As discussed above, banker is a borrower. However, banker is a privileged borrower in the sense that a banker has certain privileges that are not available to an ordinary borrower. The key aspects of the banker's privilege are that it is the customer who goes to a bank to demand repayment of his money. The banker does not seek the creditor for repayment of the debt owed to the customer. Also, demand for repayment of money has to be made as per the existing conditions. For example, ideally the demand can only be made at the branch where the customer has an account. However, with the emergence of Internet banking and other technology enabled services, this proposition has changed to allow the customers to demand for payment in other branches. Further, the position of the customer is that of an unsecured creditor. The customer cannot ask for any security on his deposit. In fact, it is the bank which imposes a number of conditions upon account opening and runs a check upon the credentials of the customer by asking for proper identification. Even if we look at the term employed, we find that the money kept by a customer in the bank is known as 'deposit' and not 'loan' taken by the bank.

The law of limitation does not have any effect upon the money given to a banker and the banker is under no obligation to return the money unless a demand is made. A banker also has the right to combine two or more accounts of a customer if the customer has two or more accounts in his name in the same capacity. However, this right does not extend to closing the

account of a customer and a banker cannot close the account of a customer without his permission. Under certain circumstances, the position of the banker becomes that of the creditor. This can either be when the customer opens a loan account and the banker obliges. Loan can also be in the form of overdraft facility or by discounting of bills and promissory notes. In all these situations, the position of the banker changes and he becomes the creditor.

4.2 TIME DEPOSIT AND DEMAND DEPOSITS

4.2.1 Meaning of the Term 'Deposit'

The term 'deposit' in general sense means a sum of money kept with the bank over which the bank provides interest. If we look at the Indian banking law, we find that the term has been defined differently for banking and non-banking companies. Section 45I(bb) of the Reserve Bank of India Act 1934 defines 'deposit' to include 'any receipt of money by way of deposit or loan or in any other form'. This does not include the following:

(a) Amounts raised by way of share capital;

(b) Amounts contributed as capital by partners of a firm;

(c) Amounts received from a scheduled bank or a co-operative bank or any other banking company as defined in clause (c) of Section 5 of the Banking Regulation Act 1949;

(d) Any amount received from development Bank, a State Financial Corporation, any financial institution specified in or under Section 6A of the Industrial Development Bank of India Act 1964 or any other institution that may be specified by the Bank;

(e) Amounts received in the ordinary course of business as security deposit, dealership deposit, earnest money or advance against orders for goods, properties or services;

(f) Any amount received from an individual or a firm or an association of individuals (not being a body corporate), registered under any enactment relating to money lending;

(g) Any amount received by way of subscription

The section by way of explanation provides that any credit given by a seller to a buyer on the sale of any property is not a deposit.

For Non-Banking Financial Institutions, Reserve Bank issued the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions 1998 wherein paragraph 2(xii) defines 'public deposit' as "a deposit as defined under Section 45 I(bb) of the Reserve Bank of India Act, 1934" excluding the following:

(a) Any amount received from the Central Government or a State Government or any amount received from any other source whose repayment is guaranteed by the Central Government or a State Government;
(b) Any amount received from a local authority or a foreign Government or any other foreign citizen, authority or person;
(c) Any amount received from the
    - Industrial Development Bank of India or
    - Life Insurance Corporation of India or
    - General Insurance Corporation of India and its subsidiaries or
    - Small Industries Development Bank of India or
    - Unit Trust of India or National Bank for Agriculture and Rural Development or
    - Electricity Board constituted under the Electricity (Supply) Act 1948, or
    - Tamil Nadu Industrial Investment Corporation Ltd., or
    - National Industrial Development Corporation of India Ltd., or
    - Rehabilitation Industries Corporation of India Ltd., or
    - Industrial Credit and Investment Corporation of India Ltd., or
    - Industrial Finance Corporation of India Ltd., or
    - Industrial Investment Bank of India Ltd., or
    - State Trading Corporation of India Ltd., or
    - Rural Electrification Corporation Ltd., or
    - Minerals and Metals Trading Corporation of India Ltd., or
    - Agricultural Finance Corporation Ltd., or
    - State Industrial and Investment Corporation of Maharashtra Ltd., or
    - Gujarat Industrial Investment Corporation Ltd., or
    - Asian Development Bank or
    - International Finance Corporation or
    - any other institution that may be specified by the Reserve Bank of India in this behalf ;
(d) Any amount received by a company from any other company;
(e) Any amount received by way of subscriptions to any shares, stock, bonds or debentures pending allotment of shares, stock, bonds or debentures;
(f) Any amount received by way of calls-in-advance on shares, in accordance with the Articles of Association of the company;

(g) Any amount received from a director of a company or any amount received from shareholders by a private company or by a private company which has become a public company under section 43A of the Companies Act 1956;
(h) Any amount raised by issue of bonds or debentures secured by mortgage of any immovable property of a company; or by any other asset or with an option to convert them into shares in the company;
(i) Any amount brought in by the promoters by way of unsecured loan in pursuance of stipulations of lending institutions;
(j) Any amount received from a Mutual Fund governed by Securities and Exchange Board of India (Mutual Funds) Regulations 1996;
(k) Any amount received as hybrid debt or subordinated debt the minimum maturity period of which is not less than sixty months;
(l) Any amount received from a relative of a director of an NBFC;
(m) Any amount received by issuance of commercial paper;
(n) Any amount received by a systemically important non-deposit taking non-banking financial company by issuance of 'perpetual debt instruments'.

4.2.2. Types of Deposit Accounts:

Bank deposits are of two kinds-

(a) Demand deposits
(b) Time deposits

Demand deposits are deposits which are payable on demand. The demand can be through any mode such as cheque, demand draft, money transfer etc. Demand deposits do not have any fixed period of maturity. Time deposits are not payable on demand. These deposits have a fixed period of maturity and cheque facility is not available for these deposits. In real life however, banks do not have any deposit accounts by the name of –demand or time deposits. Depending upon the features of an account, a deposit account will either be demand or time deposit account.

There are four types of deposit accounts. These are – Saving Bank, Current deposits, Fixed Deposits and Recurring Deposits. However, recently, a number of banks have floated new schemes which might be based upon a merger of features of two or more deposit accounts. For example, presently, Standard Chartered bank provides for two-in-one account where the available interest rates are those of a fixed deposit along with the flexibility of savings or current account. Another example is Auto- Sweep Account where a customer's saving bank account is linked with a deposit account and any extra amount above a threshold

limit is automatically transferred to fixed deposits which has a higher rate of interest than the savings account.

Savings bank accounts are very popular among individuals. These are also demand deposits subject to certain restrictions. There are certain chief features of these accounts. First, usually there is a cap on the maximum number of withdrawals and the maximum amount of withdrawals in a certain period. Second, cheque facility is provided to the account holder. Third, as per the new guidelines, banks are free to determine the rate of interest. Rate of interest varies between 4 to 8 per cent. Fourth, these accounts usually have a minimum balance. However, as per recent guidelines of the Reserve Bank, banks are also directed to open 'No Frill Account' (No minimum balance). Finally, these accounts are widely preferred by small investors.

Current accounts (demand deposits) are usually opened for transacting business for there is no limit on the number of transactions or the amount of transactions. Businessmen who need ready cash for a number of purposes open these accounts to transact their daily business. The chief features of these accounts can be enlisted as follows.

(a) Preferred by businessmen/ companies and other business entities for it provides continuous liquidity.
(b) No cap on the number or amount of withdrawal.
(c) Cheque facility is provided.
(d) Banks generally do not pay interest on these accounts.
(e) The facilities provided under this account are charged some additional service charges.
(f) These accounts run on a continuous basis.
(g) Cost of maintaining this account is high.
(h) Usually banks insist upon keeping a minimum balance.
(i) These accounts can be opened by individuals/ societies/trusts/ Hindu Undivided Families (HUFs) etc.

Fixed deposits are a type of term deposits. They are so known as the amount deposited is locked/fixed for a certain period and is only available to the customer upon maturity, that is, upon the completion of the period for which it is fixed. For example, if an amount is fixed for a term of five years, the amount can be recovered only after the said period. As the money is locked for a fixed period, the rate of interest is higher in comparison to savings accounts, which are in the nature of demand accounts wherein the bank has to honour the demand for return of deposit by the customer at any time. Money can be withdrawn from fixed deposits

prematurely but the banks usually impose a penalty for that or provide a lesser rate of interest depending on the period of withdrawal.

Recurring Deposits are a special type of fixed deposits. These accounts generally ask for deposit of a fixed amount every month over a period of time. At times, even higher amount can be deposited. These accounts are ideal for customers, who do not have a lump sum amount to deposit and want to build a fund over a period of time. If there is default in payment of any instalment, a penalty might be imposed. Most of these accounts allow premature withdrawal after imposing a penalty or reducing the rate of interest.

4.2.3 Regulation of Deposits by Reserve Bank:

Both domestic and deposits of Non-Resident Indians are regulated by the Reserve Bank. As per the instructions of Reserve Bank, interest free deposits cannot be accepted by banks. Banks are free to determine savings banks deposit rates from 25 October 2011. This right is subject to two conditions. Firstly, banks have to offer a uniform interest rate on savings bank deposits up to Rs. 1 lakh, irrespective of the amount in the account within this limit. Secondly, banks can provide differential rate of interest for deposits over Rs. 1 lakh provided banks do not discriminate in the matter of interest paid on such deposits between one deposit and another of similar account, accepted on the same date, at any of its offices.

Reserve Bank has further instructed that the interest on savings bank accounts by scheduled commercial banks would be calculated on a daily product basis (with effect from 1 April 2010). Banks cannot engage any individual, firm, company, association or institution for mobilising deposits. Selling of deposit linked products is also prohibited except through agents employed to collect door-to-door deposits under special scheme. Reserve Bank has allowed banks to use the services of Non-Governmental Organizations (NGOs), Self Help Groups, Micro Finance Institutions and other Civil Society organizations as intermediaries. This includes collection of deposits using Business Facilitator and Business Correspondent models. For deposits of NRIs, banks can offer differential rate of interest on Non-Resident External (NRE) term deposits of ₹ 15 Lakh and above.

Reserve Bank has issued a number of guidelines for customer identification process. These guidelines popularly known as ‘Know Your Customer’ (KYC) guidelines are to be followed by banks for the opening of accounts. The documents which can be asked by the banks from individuals for customer verification include passport, PAN card, Voter’s Identity Card, Driving License, Identity Card and Letter from a recognized public authority or public servant verifying the identity and residence of the customer. In order to verify the address of the individual customer, the bank can insist upon the telephone bill, bank account statement,

letter from recognized public authority, electricity bill, ration card or letter from the employer.

In the case of companies, banks can ask for certificate of incorporation, Memorandum of Association, Articles of Association, Copy of PAN allotment letter, Copy of telephone bill, power of attorney granted to the company's managers, officers or employees to transact business or resolution of the Board of Directors to open an account for verification of the name of the company, its principal place of business, its mailing address and its telephone/fax number. Partnership firms can be asked for their registration certificate (if registered), partnership deed, power of attorney granted to a partner or an employee of the firm to transact business, telephone bills or any other officially valid document which identifies the partners and the persons holding the Power of Attorney as proof of their legal name, address, names of partners and their addresses, telephone numbers etc. Similar requirements are also provided for opening accounts of trusts and foundations and proprietorship concerns.

Recently, the KYC guidelines have been amended and opening of bank accounts for individuals has been made easier. Some of the key guidelines are:

(a) If the address on the document submitted for identity proof by the prospective customer is same as that declared by him/her in the account opening form, the document may be accepted as a valid proof of both identity and address.
(b) Introduction is not mandatory for opening accounts.
(c) Banks can accept Aadhaar letter as proof of identity and address.
(d) NREGA Job Card will be an 'officially valid document' for opening of 'Small Accounts' at banks.

4.2.4 Safety of Bank Deposits:

Bank deposits are insured by Deposit Insurance and Credit Guarantee Corporation (DICGC) which is a wholly owned subsidiary of Reserve Bank. The chief features of the insurance scheme provided by DICGC are:

- All types of deposits are insured, which include savings, fixed, current and recurring.
- Deposits received from a foreign Government, the Central Government, deposits received outside India or another bank are not insured.
- DICGC insures deposits only up to ₹ 1 lakh.
- The scheme is compulsory. Banks have to compulsorily get their deposits insured.
- DICGC charges a nominal premium from the banks. This premium is not charged upon the customer. At present, banks have to pay premium to DICGC at the rate of 10 paise per ₹ 100/- per annum on all deposits.

- This scheme is applicable to all banks.
- Deposits kept in different branches of a bank are clubbed together for determining the insurance cover.
- Deposits held in joint accounts in more than one branches of a bank are treated as single holder, if the names of the holder appear in the same order in all the accounts.
- In case of bank liquidation, the list of depositors is sent by the liquidator to the DICGC who pays the sum to the liquidator for distribution among the depositors.
- If there is a merger of banks, DICGC gives the amount to the bank, which takes over the other bank.

4.3 SUMMARY

The relationship between a banker and customer has many facets. Primarily, the relationship between a banker and customer is of debtor and creditor where the banker is a debtor to the customer. Other than that, banker acts as a trustee by keeping the customer's valuable assets in lockers and safe vaults. Banker also acts as an agent of his customer when he collects cheques, drafts or purchases securities on behalf of the customer. Besides these, banker can also act as a bailee by keeping valuables and documents of the customer. However, despite being a borrower, the position of a banker is privileged. The term 'deposit' in general terms means a sum of money kept with a bank over which the bank provides interest. Bank deposits are of two kinds- Demand deposits and Time deposits. Demand deposits are deposits which are payable on demand. Time deposits are so known as the amount deposited is locked or fixed for a certain period and is only available to the customer upon maturity, that is, upon completion of the period for which it is fixed. Bank deposits are insured by Deposit Insurance and Credit Guarantee Corporation (DICGC), which is a wholly owned subsidiary of Reserve Bank. DICGC insures deposits only up to ₹ 1 lakh. DICGC charges a nominal premium from the banks. This premium is not charged upon the customer.

4.4 KEYWORDS

1. Banker
2. Privileged Borrower
3. Time Deposit
4. Demand Deposit
5. Saving Bank Account
6. Current Deposit
7. Fixed Deposits

8. Recurring Deposits
9. KYC Guidelines
10. Deposit Insurance and Credit Guarantee Corporation

4.5 SELF ASSESSMENT QUESTIONS

1. How is banker a privileged borrower?

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2. What do you mean by the term 'deposit'? What are excluded from the ambit of deposit?

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3. Elaborate on the different types of deposit accounts.

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4. What is the role of Reserve Bank in the regulation of deposits?

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5. How is the safety of bank deposits ensured by Deposit Insurance and Credit Guarantee Corporation?

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UNIT- 5: MISCELLANEOUS ASPECTS OF BANKING

Structure

5.0 Objectives
5.1 Introductions
5.2 Automation of banks
5.3 Internet banking
5.4 Islamic banking
5.5 Summary
5.6 Keywords
5.7 Self Assessment Questions
5.8 References

5.0 OBJECTIVES

- To Have an insight into how technology has transformed banking sector.
- To understanding the meaning and forms of bank automation.
- To look into the concept of Internet banking and the convenience offered by it.

5.1 INTRODUCTION

The advent of computer and Internet has resulted in the beginning of a new era in the form of information technology era. Just like its impact on different spheres of human activities, information technology has also transformed Indian banking system significantly. Technology has affected all aspects of banking industry be it, conduct of day to day banking transactions, interbank transactions, bank reporting methods or any other processes. Bank automation started towards the early 1980s with a key role being played by Reserve Bank by the introduction of computers in bank offices followed by total branch automation. With this, the modern day banking services have not only become more efficient but also witnessed a complete overhauling to meet the customer demands.

5.2 AUTOMATION OF BANKS

Automation refers to the use of automatic equipment in a system. Bank automation refers to operation of banks by automatic equipments cutting down the need for human assistance. Bank branch automation refers to the process of linking of customer service desk in a bank office with the customer's record in branch office. Branch automation is highly effective in reducing transaction time due to reduction in required paperwork. As mentioned earlier, the first step in this regard was introduction of computers. This was followed by branch automation and subsequently the thrust is towards Core Banking Solutions under which the different branches of a bank are connected so that a customer can operate his account from any branch, without being bothered about the branch he opened his account with. The chief features of Core banking Solutions are:

(a) Centralized Data Management.
(b) Assistance in Internet and mobile banking.
(c) Transaction of business from any branch or ATM.
(d) Higher transactional accuracy.
(e) Efficient fund managements due to immediate availability of funds.

Besides branch banking, automated teller machines or ATMs is also vastly responsible for improving the way banking services are made available. A new step in this regard is introduction of biometric ATMs wherein operation is dependent upon verification of

face recognition, fingerprints, eyes or voice recognition. Biometric ATMs are a more viable alternative to regular ATMs especially in rural areas wherein due to high level of illiteracy, rural people face handicaps in ATM operation. At the same time, efforts are on to introduce multilingual ATMs in India.

Reserve Bank has recently come up with Automated Data Flow (ADF). Banks have been advised to implement it at the earliest. As a Central Bank, RBI has to seek a lot of data from banks and ADF aims at ensuring submission of data from bank systems directly to Reserve Bank without any intervention. As per the Approach Paper placed by Reserve Bank on its website, such direct transfer means that data and information available to CBS and other IT systems of the banks must be submitted to Reserve Bank without any manual aggregation, conversion or filing of data. Traditionally, banks communicate via hard copies, fax and PDF files. For the purpose of ADF, Reserve Bank has classified banks into six clusters depending upon the process and technology maturity of the bank. ADF has four components. These are;

(a) Data Acquisition Layer
(b) Data Integration and Storage Layer
(c) Data Conversion Layer
(d) Data Submission Layer

Efforts are being made to introduce satellite banking, especially in hilly areas where communication services are weak due to geographical reasons.

5.3 INTERNET BANKING

In layman’s terms, e-banking refers to providing banking products and services directly to customers through electronic communication channels. Basel Committee defines e-banking as “The provision of retail and small value banking products and services through electronic channels, such products and services can include deposit taking, lending, account management, the provision of financial advice, electronic bill payment products and services such as electronic money.” Internet banking has been introduced in India pretty late but has progressed very quickly. Online presence of banks is a necessity now and all banks have a website of their own. These websites, besides offering informational services, are also means of advertisement wherein banks are able to reach large target groups with information about services, schemes and facilities provided by them. Internet banking also involves, online transactions, balance enquiries, online booking of tickets and making payments for it etc. All

kind of value added services can be carried out via Internet banking from the ease of one's home without physically visiting a bank with no time and geographical constraints.

Banking services offered through Internet are of three types:

(a) The Basic Level Service - Banks' websites provide information on different products and services offered to customers and members of public.

(b) Simple Transactional Websites - These websites allow customers to submit their orders, queries and applications for different services. Fund-based transactions are not allowed under this type of Internet services.

(c) Fully Transactional Websites - These websites allow customers to operate accounts for transfer of funds, payment of different bills, subscribing to products of bank and purchase and sale of securities.

Types of risks associated with Internet banking:

(a) Operational risk/Transactional risk:

Operational risk can occur in the form of –

- Inaccurate processing of transactions.
- Non enforceability of contracts.
- Vulnerability in data integrity, data privacy and confidentiality.
- Unauthorized access intrusion to bank's systems and transactions.
- Negligence by customers and employees.
- Fraudulent activity of employees and crackers /hackers.

(b) Security risk:

Security risk can occur due to unauthorized access to a bank's accounting system, risk management system, portfolio management system and other information system. This may primarily lead to loss of data, theft, tampering with customers' information and denial of customer service due to disablement of bank's internal computer system. In addition, the security risk may involve additional cost of repair and loss of reputation of the bank.

(c) **Reputational Risk:**

People can lose confidence in e-services provided by bank having a direct impact upon bank-customer relationship. Chief reasons for reputational risk are non satisfaction of customer expectation, regular security breaches, issues arising in communication access limiting customer's access to funds/account and inadequate information to customers about services provided over Internet, terms of usage, usage manuals.

(d) **Legal risk:**

Legal risk can arise from violation of laws or prescribed practices. Since the rules pertaining to Internet banking are still in nascent stage, it may lead to ambiguity in application of laws to new situations arising as a result of Internet banking services. Legal problems may persist in the issues arising out of validity of e-agreements, law relating to customer disclosure and privacy.

(e) **Money laundering risk:**

Criminals can use anonymity of Internet to launder money. Proper customer identification norms can help banks to avoid money laundering. Banks should also resort to – (i) Designing proper screening techniques; (ii) Developing audit trails; (iii) Framing internal policies to check suspicious transactions; and (iv) Conducting Periodic compliance reviews.

(f) **Cross border risks:**

Different jurisdictions prescribe different norms on customer protection, money-laundering, privacy regulation, reporting procedures etc. The banking transactions conducted over the Internet may expose a bank to the risk of non-compliance with applicable laws in different jurisdictions. The cross border transactions are also associated with the increased operational risks. Movement of foreign currency used in e-transactions is also subject to market risk.

(g) **Strategic risks:**

In case of introduction of new products or service, the popularity of it is a strategic risk for the bank. Banks can play safe by basing their product or service on solid market research and provide it with the best technology in market. This involves additional cost for the banks and banks may not be always able to recover the said cost.

(h) **Other risks:**

- When bank extends credit through remote banking procedures, banks are unable to properly comprehend the credit-worthiness of the customer, making it vulnerable to credit risk. Banks are also exposed to risk of default by issuer of e-money to redeem electronic money.
- Banks undertaking electronic money transactions should have adequate cash to settle customer demands. This exposes banks to liquidity risks.
- Banks are vulnerable to market risk due to fluctuations in foreign exchange rates.
- Banks are susceptible to various technological risks such as unauthorized access, destruction or corruption of data,, denial of customer access and network failure.

Crackers can use e-mail bomb wherein customer's mail account is filled with junk. Denial-of-service (DoS) attacks are also a common way by which bank network is attacked making it incapable to performing regular functions. Besides these, crackers can use sniffer attack through devices that are capable of capturing passwords and confidential information. Crackers can also get unauthorised access via holes which are defects in hardware, software or policy.

Internet Banking in India – Guidelines:

Reserve Bank of India had set up a 'Working Group on Internet Banking' to examine different aspects of Internet Banking (I-banking). The Working Group came up with a number of guidelines focussing on three major areas -(i) Technology and security issues, (ii) Legal issues and (iii) Regulatory and supervisory issues. Some of the key recommendations under each sub-head are mentioned below:

(a) Technology and Security Standards:

i. Banks should designate a network and database administrator with defined roles.

ii. Banks should have a security policy duly approved by the Board of Directors.

iii. Duty of Security Officer / Group dealing exclusively with information systems security and Information Technology Division should be segregated.

iv. Information Systems Auditor should audit the information systems.

v. Banks should introduce logical access controls to data, systems, application software, utilities, telecommunication lines, libraries, system software, etc.

vi. Banks should use proxy server type of firewall to avoid direct connection between Internet and the bank's system.

vii. Systems supporting dial up services through modem on same LAN as the application server should be isolated to prevent intrusions into the network.

viii. Banks should use PKI (Public Key Infrastructure) for secure Internet banking services. Other alternatives include- Usage of SSL (Secured Socket Layer) and the use of at least 128-bit SSL.

ix. All unnecessary services on application server such as FTP (File Transfer Protocol), telnet should be disabled.

x. Application server should be isolated from the e-mail server.

xi. All computer accesses, including messages received, should be logged.

xii. Security violations should be reported and follow up action taken. Banks should review their security infrastructure and security policies regularly and educate their security personnel and also the end-users on a continuous basis.

xiii. The information security officer and the information system auditor should undertake periodic penetration tests of the system.

xiv. Physical access controls should be strictly enforced.

xv. Banks should have proper infrastructure and schedules for backing up data.

xvi. All applications of banks should have proper record keeping facilities for legal purposes.

(b) Legal Issues

i. Banks should establish identity and make enquiries about integrity and reputation of prospective customer. Accounts should be opened only after proper introduction and physical verification of the identity of the customer.

ii. Security procedure adopted by banks for authenticating users needs to be recognized by law as a substitute for signature. Information Technology Act 2000, in Section 3(2) provides for asymmetric crypto system and hash function as a means of authenticating electronic record.

iii. Banks should institute adequate risk control measures to manage customer privacy norms.

iv. Banks should clearly notify to customers the timeframe and circumstances in which any stop-payment instructions could be accepted.

(c) Regulatory and Supervisory Issues:

i. Only banks which are licensed and supervised in India and have a physical presence in India are permitted to offer Internet banking products to residents of India.

ii. The products should be restricted to account holders only and should not be offered in other jurisdictions.

iii. The services should only include local currency products.

iv. The 'in-out' scenario where customers in cross border jurisdictions are offered banking services by Indian banks (or branches of foreign banks in India) and the 'out-in' scenario where Indian residents are offered banking services by banks operating in cross-border jurisdictions are generally not permitted and this approach should apply to Internet banking also. The existing exceptions for limited purposes under FEMA are to be allowed.

v. Overseas branches of Indian banks will be permitted to offer Internet banking services to their overseas customers subject to their satisfying in addition to the host supervisor, the home supervisor.

vi. All banks that want to offer transactional services on Internet have to obtain prior approval from Reserve Bank. After the initial approval, the banks will be obliged to inform Reserve Bank any material changes in the services / products offered by them.
vii. Banks should report to Reserve Bank every breach or failure of security systems and procedure. Reserve Bank can decide to commission special audit / inspection of such banks.
viii. The guidelines issued by Reserve Bank on 'Risks and Controls in Computers and Telecommunications' vide circular DBS.CO.ITC.BC. 10/ 31.09.001/ 97-98 dated 4 February 1998 would equally apply to Internet banking. Reserve Bank as supervisor will cover the entire risks associated with electronic banking as a part of its regular inspections of banks.
ix. Banks should develop outsourcing guidelines to manage risks arising out of third party service providers.
x. Only institutions who are members of the cheque clearing system in the country are to be permitted to participate in Inter-bank payment gateways for Internet payment.
xi. Inter-bank payment gateways must have capabilities for both net and gross settlement. All settlement should be intra-day and as far as possible, in real time.
xii. Connectivity between the gateway and the computer system of the member bank should be achieved using a leased line network (not through Internet) with appropriate data encryption standard. SSL / 128 bit encryption must be used as minimum level of security.
xiii. Banks must make mandatory disclosures of risks, responsibilities and liabilities of customers in doing business through Internet through a disclosure template.
xiv. Hyperlinks from the bank's websites should be confined to only those portals with which they have a payment arrangement or sites of their subsidiaries or principals.

Precautions for Internet Banking Users:

The problems of the Internet banking can be solved by taking certain precautions by the customers. First, passwords should be strong and changed at regular intervals. Second, logging out from the bank's website should be done using the set procedure. This is even more vital in case e-transactions are done over a non-secured wireless connection or a public computer. Third, the users should avoid going to any site from any hyperlink provided in a site. Fourth, the sensitive information such as user name, password should not be given to others. Fifth, e-mails claiming to be from customer's bank should not be provided with any

sensitive information if asked for. Sixth, password and other sensitive information should be kept in a secure place or memorised for better protection.

5.4 ISLAMIC BANKING

Islamic banking previously thought to be incompatible with Indian banking regulatory model has recently gained ground in India. In April 2013, Reserve Bank gave its approval to the first Islamic bank in Kerala. Kerala State Industrial Development Corporation is in the process of establishing Cheraman Financial Services Limited, which will be the first non-banking finance company to function. The NBFC is looking towards infrastructure and manufacturing sectors as its initial targets. Previously, the 2008 Planning Commission panel on Financial Sector Reforms had advocated for inclusion of interest-free banking. The report at page 72 provides "The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantages strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region. While interest free banking is provided in a limited manner through NBFCs and Cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system". Similar suggestions had also been put forward under the Reserve Bank Report, 2005.

Constitutional validity of Islamic Finance was upheld by Kerala High Court in *Dr. Subramaniam Swamy* v. *State of Kerala & Ors* [WP (c) No. 35180 of 2009 (s)]. Islamic banks are guided by the principles of shariah and desist from charging interest (riba). Islamic finance divided interest or riba as Riba An Nasiah and Riba Al Fadl. Riba An Nasiah is equal to the interest which is charged on loans. Riba Al Fadl refers to the excess taken in exchange of specific commodities by hand to hand purchase and sale. Islamic finance also insists upon sharing of risk. The lender is supposed to share the profit or loss incurred in the enterprise/business/ activity for which the money was lent. Further, certain transactions have been expressly prohibited. These include businesses of alcohol, speculation and gambling. Transactions not backed by real assets are prohibited as money is regarded as a mere medium of exchange which has to be supported by underlying real assets.

Islamic banks provide a number of services such as money transfer, bill collection and account opening. Islamic banks have three types of accounts-

(a) Current Account (Deposit account) - This is similar to current account of conventional banks.
(b) Investment Account – Profit or loss is shared by the investors at a pre-decided ratio.
(c) Savings Account - These accounts can have different features. Banks may or may not guarantee the initial deposit. In some cases profits might be shared.

Islamic banking differs from conventional banking in various aspects. Firstly, under Islamic banking, money is a mode of exchange which necessarily needs to be backed by real assets. Secondly, instead of focussing on collateral, banks check up the viability of the project financed. Thirdly, banks aim at maximizing profit but have to function within the parameters laid down. Thus, transactions which are expressly prohibited cannot be undertaken by banks. Fourthly, both risk and profit are shared between the investor and the bank. In conventional banking, there is no such concept and investor charges a definite rate of interest. Lastly, banks earning is the profit made on exchange of goods and services.

5.5 SUMMARY

Technology has transformed Indian Banking Sector. In the present day world, all the banks and their branches are automated. Bank automation has vastly increased the efficiency of banks resulting in better delivery of services. Reserve Bank is taking a number of initiatives in this regard to further the reach of technology and better the services provided by the banking sector. Internet banking, a step forward in this direction, is capable of providing a range of value added services.

E-banking refers to providing banking products and services directly to customers through electronic communication channels. Internet banking has been introduced in India pretty late but has progressed very quickly. Online presence of banks is a necessity now and all banks have a website of their own. These websites besides offering informational services are also a means of advertisement wherein banks are able to reach large target groups with information about services, schemes and facilities provided by them. Internet banking also involves, online transactions, balance enquiries, online booking of tickets and making payments for it etc. A number of risks are involved with Internet banking. These include operational risk, security risk, reputational risk, legal risk, money laundering risk, cross border risk, strategic risk and other risks present in traditional banking such as liquidity crisis, credit risk and so on. Reserve Bank had set up a ‘‘Working Group on Internet Banking’ to examine different aspects of Internet Banking (I-banking). The Working Group came up with a number of guidelines focussing on three major areas -(i) Technology and security

issues, (ii) Legal issues and (iii) Regulatory and supervisory issues. Reserve Bank has asked commercial banks to expand reach of Internet and mobile banking services. Reserve Bank's Payment Vision for 2012-15, aims to promote Internet and mobile based transactions.

5.6 KEY WORDS

1. Automation
2. Internet Banking
3. Automated Data Flow
4. Branch Automation
5. Core Banking Solution
6. Internet banking
7. Risk
8. Money Laundering
9. Security Risk
10. Reputational Risk
11. Operational Risk.

5.7 SELF ASSESSMENT QUESTIONS

1. What is the impact of bank automation?

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2. Discuss the chief features of Core Banking Solutions.

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1. Why is the Reserve Bank advising banks to implement ADF? Point out the components of ADF.

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2. What are the advantages of Internet banking?

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5. Mention the risks involved in Internet banking under the following sub-heads:

   (i) Security Risk

   (ii) Reputational Risk

   (iii) Cross-border risk

(iv) Money Laundering Risk.

(v) Legal Risk.

6. Mention few of the key recommendations given by the 'Working Group on Internet banking', which are to be compulsorily followed by the banks in providing Internet banking services under the following sub-heads-

   (i) Technology and Security

   (ii) Legal Issues

   (iii) Regulatory and Supervisory Issues.

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BLOCK – II

UNIT-6: REGULATING BANKS

Structure:

6.0 Objectives
6.1 Introduction
6.2 Regulation of India's banking sector
6.3 Summary
6.4 Keywords
6.5 Self Assessment Questions
6.6 References

6.0 OBJECTIVES

- To able understand need for bank regulation.
- To highlighting role of Reserve Bank in bank regulation.
- To appreciating the ways in which different aspects of banking are regulated.

6.1 INTRODUCTION

The 2007-2008 subprime crises in USA and the resultant global recession highlighted the need for bank regulation. Banks have always been the subject of governmental regulation and in comparison to other financial institutions; banks require greater regulation because of their instrumental role in a country's economy. Banking sector is directly connected with national and global economy and has a direct impact on a country's economic growth. This coupled with the fragile nature of the financial system has always prompted governments to lay down parameters of liquidity requirement and other requirements.

A major theory floated in support of bank regulation is 'Too big to fail' which provides that there are some financial institutions that are so big in nature that they cannot be allowed to fail. Activities of these institutions have a national or global impact and hence they cannot be left to be subject to self regulation and for this reason are often bailed out by governments when in difficulty. It is also necessary to regulate banks, since they are the repository of public deposits and it is government's job to protect public savings in the modern welfare state.

Not only do the banks receive deposits from individuals and other entities but they are also the channels through which government implements its economic goals making it imperative to regulate them. Other reason compelling the regulation of bank is the need for ensuring fair distribution of economic resources by having fairness in access to credit. This includes coming up with special policies for vulnerable groups in the form differential rate of interest, priority sector lending etc. Banks are also regulated to control inflation and prevent or reduce bankruptcy rate. Besides, these banks provide a number of important financial services to the government mandating regulation. Banks have to be regulated against possible misuse of money in the form of money laundering financing illegal activities etc.

Some of the key areas of governmental regulation of banks are:

(a) Restrictions on branching and new entry;

(b) Restrictions on pricing (interest rate controls and other controls on prices or fees);

(c) Line-of-business restrictions and regulations on ownership linkages among financial institutions;

(d) Restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements and/or not to hold other securities, including requirements not to hold the control of non financial companies);

(e) Compulsory deposit insurance (or informal deposit insurance, in the form of an expectation that government will bail out depositors in the event of insolvency);

(f) capital-adequacy requirements;

(g) Reserve requirements (requirements to hold a certain quantity of the liabilities of the central bank);

(h) Requirements to direct credit to favored sectors or enterprises (in the form of either formal rules, or informal government pressure);

(i) Expectations that, in the event of difficulty, banks will receive assistance in the form of "lender of last resort";

(j) Special rules concerning mergers (not always subject to a competition standard) or failing banks (e.g., liquidation, winding up, insolvency, composition or analogous proceedings in the banking sector);

(k) Other rules affecting cooperation within the banking sector (e.g., with respect to payment systems).

6.2 REGULATION OF INDIA'S BANKING SECTOR:

It we look at India's banking sector, we find that it is heavily regulated by Reserve Bank of India. The way in which Indian banks are regulated has changed slightly post the global recession. While the recession did not have much of an impact upon India due to the policies and strategies in place, still, Reserve Bank of India has taken further steps post global credit crisis. Some of the broad regulations in place are:

(a) The minimum capital adequacy ratio (CRAR) for banks in India is nine per cent. This rate is higher than the Basel norm of eight per cent. The current average CRAR for the scheduled commercial banks is over 13 per cent.

(b) Banks have to ensure minimum Tier I capital ratio of six per cent from 1 April 2010.

(c) The Cash Reserve Ratio (CRR) is currently 5.75 per cent and the statutory liquidity ratio (SLR) is currently 25 per cent ensuring that banks have adequate liquidity.

(d) Reserve Bank had issued asset-liability management (ALM) guidelines to banks. These guidelines cover liquidity risk measurement, reporting framework and prudential limits. Banks have to monitor their cumulative mismatches across all time buckets and establish internal prudential limits with the approval of the Board. The

ALM guidelines were updated in October 2007. Some of the key aspects of the guidelines are:-

(i) Organizational set up for liquidity risk management should comprise of Board of Directors (BoD), Risk Management Committee, Asset-Liability management Committee (ALCO) and Asset Liability Management (ALM) Support Group.

(ii) BoD is responsible for liquidity risk management.

(iii) Risk Management Committee has to report to the Board.

(iv) Risk Management Committee should consist of Chief Executive Officer (CEO)/Chairman, managing Director (CMD) and head of credit and market.

(v) Asset-Liability Management Committee (ALCO) has to ensure compliance with risk tolerance limits and the liquidity risk management strategy of the bank.

(vi) Banks should analyze affect of prepayment of loans, premature closure of deposits etc.

(vii) Banks should calculate their short term liquidity profiles and other obligations. For this purpose, banks can use the indicative format on estimating Short – Term Dynamic Liquidity prescribed by Reserve Bank.

(viii) Banks whose wholesale deposits have high concentration should ensure checks for addressing liquidity risk.

(ix) Banks are also required to go for collateral position management. This is very necessary for banks that may have to meet with emergency borrowing needs.

(x) Banks should put in place a system to calculate its collateral positions on a regular basis.

(xi) Banks should give special emphasis upon management of intra-day liquidity risk. Banks should have an intra-day liquidity strategy for monitoring daily gross liquidity inflows and outflows.

(xii) Liquidity costs and benefits should be included in internal product pricing, performance measurement and new product approval process.

(xiii) Banks should refrain from excessive emphasis upon a single funding source.

(e) Reserve Bank has advised banks to fix internal, Board-approved limits on their exposures to specific industries or sectors.

(f) Reserve Bank has prescribed prudential regulatory limits on banks' exposure to single and group borrowers. As per the present regulation, banks are allowed to lend up to

15 per cent of capital funds to a single borrower and up to 40 per cent of capital funds to a borrower group. In 2003, prudential limits on single and group borrower exposures and capital market exposures were extended to the consolidated level also for the entire banking group.

(g) Reserve Bank has prescribed prudential norms for banks exposure to capital market, acquired through funded and non-funded facilities. The aggregate exposure of a bank to capital markets has been restricted to 40 per cent its net worth. Within this overall ceiling, a bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds should not exceed 20 per cent of its net worth.

(h) Reserve Bank monitors each bank's real estate exposure and initiates corrective actions if necessary. As per the Reserve Bank guidelines issued in this behalf a ceiling on real estate loans should be fixed by banks' Boards. Banks are also to lay down norms relating to single/group limit for real estate loans, margins, security, repayment schedule and provisions on supplementary finance. A policy underlying the above mentioned aspects should be approved by banks' Boards in advance to prevent undue liabilities from exposure to real estate. Other norms to be followed by banks are:-

 (i) Banks should insist upon prior permission from government/local governments/ statutory authorities for the real estate project for which loan is sought.

 (ii) Banks can insist upon compliance with National Building Code (NBC).

 (iii) Banks can follow the National Disaster Management Authority (NDMA) guidelines to determine their loan policies.

 (iv) Bank credit should not be used for speculation in real estate. Banks are to keep a strict vigil on use of their credit only for construction activities.

 (v) As per the Reserve Bank guidelines, bank credit for setting up of Special Economic Zones (SEZ) is taken as exposure to commercial real estate sector for calculation of risk weight. Similar is the case where bank credit is sought for acquiring units in SEZs.

(i) Banks have been maintaining capital charge for market risk as provided under the Basel norms since the end of March 2006.

(j) Reserve Bank's guidelines on securitization do not allow upfront booking of profit by the originator in securitization of standard assets to ensure that profit booking is not the main motive behind securitization transactions of banks. Securitization principally

refers to sale of cash flows to investors from a pool of homogenous assets. Creating a pool distributes the credit risk across investors leading to greater financial vitality. Based upon the 'originate to distribute' business model, securitization makes available an alternate source of funding. Reserve Bank guidelines issued in this regard ensure that the interests of both the originators and the investors are adequately protected. Some of the key aspects of the guidelines are :-

(i) Underlying asset in a single securitization transaction has to represent the debt obligations of a homogenous pool of obligors.

(ii) Revolving credit facilities (e.g. Cash Credit accounts, Credit Card receivables etc.), assets purchased from other entities, securitization exposures and loans with bullet repayment of both principal and interest are not eligible for securitization. Other than these assets all other assets are eligible for securitization.

(iii) A minimum holding period for loans has been prescribed. This has been done to ensure that investors are not burdened with the project implementation risk. It also helps in improved underwriting standards.

(iv) A Minimum Retention Requirement (MRR) has also been prescribed for banks to carry out due diligence of loans to be securitized. The MRR which is representative of principal cash flows has to be ensured by the entity which is responsible for securitization of the loan. A number of documentation has been prescribed in this regard which has to be duly complied with by the banks.

(v) Reserve Bank has put a limit on total restrained exposure.

(vi) Prospective investors have to be made available all necessary information pertaining to credit quality, performance of individual underlying exposures, cash flows and collateral.

(vii) Originator banks have to make a number of disclosures. This includes information regarding outstanding amount of securitized assets sponsored by banks. Total amount of exposure is also to be disclosed. The above mentioned disclosures are to be made in the Notes to Annual Accounts.

(viii) Reserve Bank has prescribed a number of requirements to be met by banks other than originators.

(ix) Overseas branches of Indian banks cannot invest in other jurisdictions in case MRR has not been provided therein.

(x) Banks have been advised to perform stress test keeping in mind their securitization position.

(k) Credit deposit ratio and SLR prescription limit the degree of leverage in the banking system. Level of leverage is also regulated for the non-banking financial entities.

(l) Investment in non-Government securities (non-SLR securities) by banks is also regulated. Few of the key guidelines as contained in the Reserve Bank guidelines on investments by banks in non-SLR Securities are:-

(i) At present, banks can only invest in Commercial Papers (CPs) and Certificate of Deposits (CDs) in case of short term investment.

(ii) Investment in unlisted non-governmental securities is limited at 10 per cent of the overall non-SLR investment portfolio.

(iii) A number of disclosure requirements have also been put in place.

(iv) Banks cannot invest in unrated non-SLR securities.

(v) Banks can invest only in listed debt securities. These debt securities should be of companies which confirm with the SEBI directives issued in this regard.

(vi) Banks have to put all investment proposals (relating to non-SLR securities) for credit appraisal on par with their credit proposals.

(vii) Banks are also required to have their own internal credit analysis and rating. Reserve Bank has discouraged banks total reliance on the rating of external agencies.

(viii) Internal rating system of banks should have a quarterly or half-yearly tracking system. The system should be responsible for tracking the financial position of the issuer.

(ix) Banks should have a risk management system in place for looking into the risk involved in non-SLR investment.

(x) As per the Reserve Bank guidelines, banks have to keep in mind certain aspects on a quarterly basis, which include; (a) Total business during the reporting period. (b) Compliance of prudential limits. (c) Non performing investments. (d) Migration of issuers/issues in bank's books.

(xi) Investing banks have to compulsorily file all offer documents with Credit Information Bureau (India) Ltd. (CIBIL).

(xii) Banks have to disclose details of issuer composition of non-SLR investments and non-performing non-SLR investments in the 'Notes on Accounts' part of balance sheet.

(xiii) All spot transactions in listed and unlisted debt securities should be reported on NDS and settled through CCIL (the crucial date in this regard has to be notified by Reserve Bank).

(m) Banks' exposure to derivatives has been brought under the capital adequacy regime. Reserve Bank has been conferred power to regulate the derivative products which have the exchange rate, interest rate or credit rating as the underlying. Guidelines on derivatives have been issued covering eligibility criteria, broad principles for undertaking derivative transactions, permissible derivative instruments, risk management and corporate governance aspects as also aspects relating to both suitability and appropriateness of a derivative product for a client.

(n) Collaterised money market is regulated by Reserve Bank. Limits have been put on call money borrowing and lending. Non-bank players have been phased out of the uncollateralized call money market. Now, it is a pure inter-bank market.

(o) Reserve Bank has limited the bank's inter-bank liabilities (IBL) to twice its net worth to prevent excessive inter-connectedness within the banking system. IBL consists mainly of a bank's borrowing in the overnight call money market and money raised by selling certificate of deposits of other banks. IBL also comprises of interbank CBLO, repurchase (repo) transactions and deposits raised from retail investors. Collateralized Borrowing and Lending Obligations (CBLO) market is approached by a bank in case the bank wants to get access to cash and has government securities. In case of CBLO government securities are used as collateral making it hugely popular. Banks looking for increasing their SLR go for repo facility. Under it, a bank can get government securities in lieu of cash. Reserve Bank is concerned about management of IBL as uncontrolled liability of banks can affect the financial stability of the entire system.

(p) Reserve Bank has issued comprehensive guidelines of ownership and governance in 2003. Under the guidelines, any transfer of a bank's shares amounting to five per cent or more of its total paid up equity capital is required to be approved by Reserve Bank before the bank can register the transfer. For holdings beyond 10 per cent prior approval is required. Large industrial houses cannot have ownership of a bank beyond 10 per cent. Few of the key principles which dictate the ownership and governance guidelines are –

(i) Ownership and control of private sector banks should be well diversified.

(ii) Important Shareholders should be 'fit and proper'. The same entails acknowledgement for allotment and transfer of shares. Important Shareholders are those which have a shareholding of 5 per cent and above.

(iii) Directors and CEO of the banks should be 'fit and proper'.

(iv) All the policy and processes should be fair and transparent

(q) A number of good governance initiatives have been taken up by Reserve Bank. These include setting up Nomination Committees by private sector banks, upper age limit for non-executive directors in private sector banks, splitting the post of Chairman and managing Director in private sector banks into a part time Chairman and a managing Director etc.

(r) Section 35 B of the Banking Regulation Act 1949 provides that banks in the private sector and foreign banks in India have to take approval of the Reserve Bank for remuneration payable to their CEOs. Reserve Bank keeps a watch on executive compensation. Reserve Bank has come up with guidelines for compensation of executives at private banks. Though no limits have been fixed upon the absolute pay, the guidelines lay down the structure of pay. As suggested by International Financial Stability Board, guaranteed bonus has been banned. Similarly, banks cannot provide severance pay (excluding accrued benefits like gratuity and pension). The variable component of the compensation provided by banks to its executive cannot exceed 70% of fixed pay in a year. Further, Employees Stock Option Plan can be excluded from variable pay which can be deferred over a period of three years. Reserve Bank has also laid down guidelines for compensation of executives of foreign banks. Foreign banks have to annually declare their compensation package structure to Reserve Bank. The said compensation should comply with FSB principles. Joining bonus can be provided only for new hires and should be restricted to first year.

(s) Clearing Corporation of India Ltd (CCIL) was set up in 2001. It is responsible for clearing and settlement of transactions undertaken in Government securities, money market instruments and foreign exchange products. A number of other systems have also been put in place for reporting trades in corporate bonds. These include, first, identification of Financial Conglomerates that would be subjected to focused regulatory oversight. Second, capturing intra-group transactions and exposures (which are not being captured as of now) amongst 'group entities' within the identified financial conglomerate and large exposures of the groups to outside counterparties. Third, identifying a designated entity within each group that would collate data in

respect of all other group entities and furnish the same to its regulator (principal regulator for the group). Fourth, formalizing a mechanism for inter-regulatory exchange of information.

(t) Reserve Bank has come up with a number of regulations on Non Banking Financial Institutions. It has introduced a Fair practice Code for NBFCs. Some of its chief provisions are:

i. Loan application forms should include necessary information which affects the interest of the borrower.
ii. The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications.
iii. NBFCs shall mention the penal interest charged for late repayment in bold in the loan agreement.
iv. Not furnishing a copy of the loan agreement or enclosures quoted in the loan agreement is an unfair practice.
v. NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim NBFCs may have against borrower.
vi. NBFCs shall ensure that the staffs are adequately trained to deal with the customers in an appropriate manner.
vii. NBFCs have to display the name and contact details (Telephone / Mobile numbers as also email address) of the Grievance Redressal Officer who can be approached by the public for resolution of complaints against the Company.

(u) Financial Stability Unit (FSU) has been set up within the Reserve Bank for conducting macro-prudential surveillance and stress tests. The main functions of the FSU would include: -

i. Conduct of macro-prudential surveillance of the financial system on an ongoing basis.
ii. Preparation of financial stability reports.
iii. Development of a database of key variables which could impact financial stability, in co-ordination with the supervisory wings of the Reserve Bank.
iv. Development of a time series of a core set of financial indicators.
v. Conduct of systemic stress tests to assess resilience.
vi. Development of models for assessing financial stability in due course.

(v) To develop the corporate bond market Reserve Bank of India has formulated draft guidelines on repo transactions in corporate debt securities.

6.3 SUMMARY

India's banking sector is heavily regulated by Reserve Bank. Post global crisis, a number of fresh steps have been taken to prevent any similar crisis in India. Reserve Bank has kept a higher or at par bench mark in all aspects of financial regulation. For example, the capital adequacy ratio in India is higher that the BASEL norms. A number of guidelines on asset-liability management, banks exposure to capital markets, real estate, securitisation, investment in non-government securities, inter-bank liabilities, corporate governance etc. are in place. Clearing Corporation of India Ltd. Has been established in 2001 and is responsible for settlement of transactions undertaken in government securities, money market instruments and foreign exchange products. A number of regulations have also been set in place for regulation of NBFC's. Financial Stability Unit (FSU) has been set up for conducting macro-prudential surveillance and stress tests.

6.4 KEY WORDS

1. Regulation
2. Capital Adequacy Ratio
3. Asset Liability management
4. Good Governance Initiatives
5. Clearing Corporation of India
6. Fair Practice Code For NBFC's
7. Financial Stability Unit.

6.5 SELF ASSESSMENT QUESTIONS

1. What does the theory of 'Too big to fail' provide?

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2. Mention some key areas of governmental regulation of banks.

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3. Discuss the steps taken by Reserve Bank for regulation of Indian banking sector.

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4. What is Fair Code for NBFC's? What are its chief provisions?

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UNIT-7: THE CENTRAL BANK AS REGULATOR

Structure:

7.0 Objectives

7.1 Introductions

7.2 Central bank of India

7.3 Organizational structure of RBI

7.4 Major functions performed by RBI

- 7.4.1 Bank of issue
- 7.4.2 Banker to the government
- 7.4.3 Banker's bank
- 7.4.4 Monetary policy formulation and control
- 7.4.5 Regulator of banking system and payment and settlement system
- 7.4.6 Custodian of foreign exchange control
- 7.4.7 Other promotional functions

7.5 Summary

7.6 Keywords

7.7 Self Assessment Questions

7.8 References

7.0 OBJECTIVES

- To understand the meaning and role of Central Banks.
- To establishment, organizational structure and functions of Reserve Bank.
- To appreciating the role of Reserve Bank as the guardian of Indian Banking Sector.

7.1 INTRODUCTION

Central bank is the highest monetary institution of a country. It is the apex body and as such is responsible for formulating, implementing and monitoring the financial policy of a country. Each country has a central bank entrusted with the task of managing the monetary system of that country. Central banks have certain key functions which are common for all jurisdictions. Besides these key functions there are certain responsibilities assigned to these banks. Key functions of central bank include policy formulation, issue of currency, banker to government and banker to banks, manager of foreign exchange and credit system. In India, Reserve Bank of India is the central bank.

7.2 CENTRAL BANK OF INDIA

The Reserve Bank of India was established on 1 April 1935 under the Reserve Bank of India Act 1934 on the basis of recommendations of the Royal Commission on Indian Currency and Finance (Hilton- Young Commission). The Commission recommended that a Central Bank should be created and the control of currency and credit should be separated from the government. Reserve Bank was originally privately owned but was put under governmental control under the provisions of the Banking Regulation Act 1949. At present it has 19 regional offices and 9 sub-offices. It also has five training establishments and three fully owned subsidiaries – Deposit Insurance and Credit Guarantee Corporation of India (DICGC), National Housing Bank (NHB) and Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL).

The preamble of the Reserve Bank of India Act 1934 provides the functions of the Bank as 'to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'. Chapter III of the Act elaborates upon the Central banking functions. Few of the main provisions are:

(a) Obligation of the bank to transact government business. (Section 20)

(b) Right to transact government business in India. (Section 21)

(c) Obligation to transact government business of States on agreement. (Section 21A).

(d) Right to issue bank notes. (Section 22).

(e) Obligation to supply different forms of currency. (Section 39).

(f) Keeping the Cash Reserves of Scheduled banks. (Section 42)

The Reserve Bank is the chief monetary authority of the country and is entrusted with the task of formulating and implementing the monetary policy of the country. It is also responsible for maintaining price stability and credit flow to productive sectors. As regulator of the financial system, it is in charge of the over- all smooth running of the banking and financial systems keeping in mind the interest of the depositors and the public. Reserve Bank also facilitates external trade and payment and is also responsible for maintenance of foreign exchange market in India. As mentioned above, it is the issuer of currency and destroys currency and coins which are not fit for circulation. It is also a banker to the banks and all banks maintain accounts with it. In addition, it also functions as banker to the government.

Since its establishment in 1935, the Reserve Bank has functioned quite effectively in many aspects. In the initial years, the Reserve Bank has acted as central bank for Burma and subsequently, for Pakistan. In 1949, the Reserve Bank was nationalized and became a fully owned body of Government of India. In 1950s, the Reserve Bank became active agent and participant in India's planned economic development. Under the leadership of Jawaharlal Nehru, the agricultural sector was subject to a centrally planned economic policy and Reserve Bank was asked to support the plan by providing loans. In 1960s, the Reserve Bank was asked to establish and monitor deposit insurance system to take care of the investors' problems in case of collapse of banks. It was also entrusted with the task of playing a key role in controlling and supporting the public sector banking. Meanwhile, the Cooperative Banks came under RBI Regulation in 1966.

In 1969, fourteen major commercial banks were nationalised. In the wake of reinforcement of regulations in the financial sector by the Government of India, the Reserve Bank increased its policies on interest rates, reserve ratio and visible deposits during 1970s and 1980s. In 1973, the Reserve Bank strengthened exchange control by amending Foreign Exchange Regulation Act (FERA). This has been instrumental in controlling the effect on inflation. Priority sector lending targets were introduced in 1974, which was supplemented by setting up regional rural banks in 1975. In the second half of 1980s, several committees were established to look into the Indian economy. The Sukhamoy Chakravarthy and Vaghul Committee Reports in 1985 triggered the reforms in the financial market. The role of Reserve Bank also increased as a result of various committee reports.

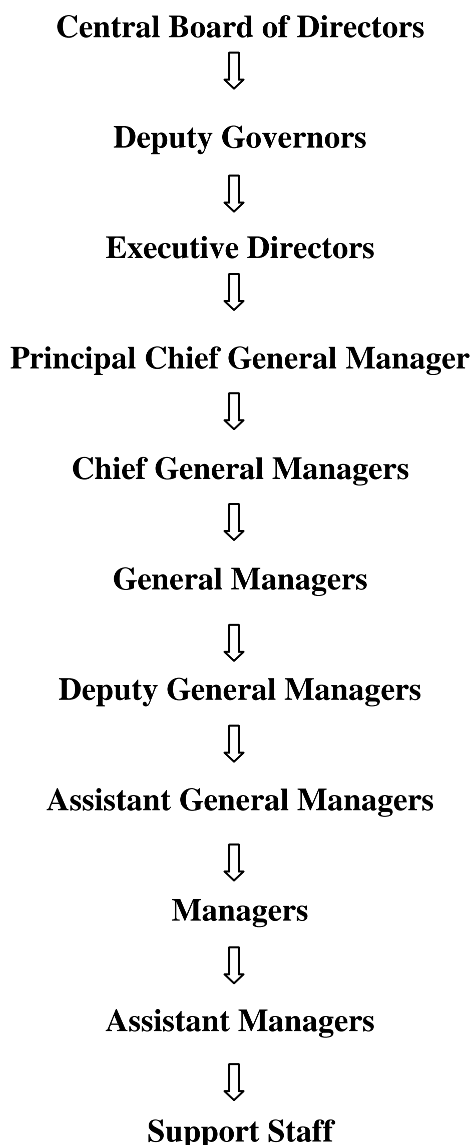
The 1990s started with the balance of payment crisis in India. Since the Indian Rupee was steeply falling against US dollar, the Narsimahman Committee advised for the

restructuring of financial sector. New guidelines were formulated for establishing private banking sector in 1993. Exchange rates became market determined and the bank interests were deregulated. The Board for Financial Supervision was set up in 1994 to supervise commercial banks, financial institutions and non-banking finance companies. In February 1995, Bharatiya Reserve Bank Note Mudran Limited was entrusted with the function of producing the banknotes. The regulation of Non- Banking Finance Companies was strengthened in 1997. In the next year, multiple indicator approach for monetary policy was adopted, which looks at variety of economic indicators and their impact on economic developments.

In June 2000, the Foreign Exchange Management Act replaced Foreign Exchange Regulation Act to improve the foreign exchange market, international investments and transactions in India. Online banking services were allowed by the Reserve Bank in 2001, and the national electronic fund transfer facility was developed in 2004. It followed the establishment of full fledged daily liquidity adjustment facility and Market Stabilisation Scheme. In 2002, Clearing Corporation of India Limited (CCIL) started clearing and settlement in government securities. The Fiscal Responsibility and Budget management Act was enacted in the next year. In 2005, focus shifted on financial inclusion and increasing outreach of banking sector. Reserve Bank was empowered to regulate money, forex, G-Sec and gold related securities market in 2006 and also to regulate Payment System in 2007. In the subsequent years, the Reserve bank has made efforts to minimise impact of global financial crisis. It has also developed as a knowledge institution in the recent past to spread awareness in the public.

Presently as per the suggestions of the Financial Sector Legislative Reforms Commission, talks are on for the creation of Financial Stability Development Council (FSDC), a super regulator in charge of maintaining financial stability in the country. The FSDC board is to be chaired by the Finance Minister and is to comprise of all the regulators of the financial sector.

7.3 ORGANIZATIONAL STRUCTURE OF RBI



The Central Board of Directors is at the top of the Reserve Bank's organisational structure. The Central Board of Directors is appointed by the Government under the provisions of the Reserve Bank of India Act 1934. Fourteen Directors on the Central Board are nominated by the Central Government for a period of four years. These include ten Directors, representing the different sectors of the economy such as agriculture, trade, industry etc. Four Directors are nominated from the four Local Boards. Reserve Bank has four Local Boards. These are constituted by the Central Government under the RBI Act, one each in the northern, southern, eastern and western area of the country. These are located in Mumbai, Kolkata, New Delhi and Chennai. One Government official representing the

Government is also nominated and he remains on the Board 'during the pleasure of the Central Government'. Governor is the chief executive of Reserve Bank. He and a maximum of four Deputy Governors remain as the ex-officio Directors on the Central Board. The Boards have five members each. These members are appointed by the Central Government for a term of four years.

Thus the Central Board of Directors comprises of:

1. Official Directors – A. Governor (1); B. Deputy Governors (4).
2. Non- Official Directors – A. Directors nominated by the Central Government to represent each local board (4); B. Directors nominated by the Central Government having expertise in various segments of economy (10); C. Representative of Central Government (1).

The Central Board functions through a number of committees and sub-committees. The Chief among them are:

(a) Board for Financial Supervision (BFS) - BFS functions as a committee of the Central Board and is responsible for supervising different financial entities such as banks, financial institutions and non-banking financial companies. It is chaired by the Reserve Bank Governor. The Deputy Governors act as the ex-officio members of the Board. Besides them, one Deputy Governor is nominated as the Vice-Chairperson. It plays a key role in policy formulation.

(b) Audit Sub-Committee - Audit Sub-Committee is responsible for assisting the BFS. It is headed by the Deputy Governor in charge of regulation and supervision. Two Directors of the Central Board act as its members. The sub-committee is responsible for looking into the statutory audit and internal audit in banks and financial institutions.

(c) Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) - BPSS is chaired by the Reserve Bank Governor. Two Deputy Governors, three Directors of Central Board and some other permanent invitees are its members. BPSS is responsible for regulating and supervising payment and settlement system.

Reserve Bank has 26 Departments looking over different aspects of financial management. These are:

(a) Internal Debt Management Department
(b) Department of External Investments and Operations
(c) Monetary Policy Department
(d) Financial Markets Department

(e) Department of Banking Supervision
(f) Department of Banking Operations and Development
(g) Department of Non- Banking Supervision
(h) Urban Banks Department
(i) Rural Planning and Credit Department
(j) Foreign Exchange Department
(k) Financial Stability Unit
(l) Department of Government and Bank Accounts
(m) Department of Currency Management
(n) Department of payment and Settlement System
(o) Customer Service Department
(p) Department of Economic and Policy Research
(q) Department of Statistics and Information Management
(r) Human Resource management Department
(s) Department of Communication
(t) Department of Expenditure and Budgetary Control
(u) Department of Information Technology
(v) Premises Department
(w) Secretary's Department
(x) Rajbhasa Department
(y) Legal Department
(z) Inspection Department.

As mentioned earlier, Reserve Bank has three fully - owned subsidiaries. These are:

(a) Deposit Insurance and Credit Guarantee Corporation (DICGC) – DICGC is governed by the Deposit Insurance and Credit Guarantee Corporation Act 1961. The preamble to the Act provides that the purpose of establishing the Corporation is to provide for insurance of deposits and guaranteeing of credit facilities. Some key features of DICGC are:
    i. Authorised capital of the Corporation is rupees 50 crore, which is fully issued and subscribed by the Reserve Bank of India.
    ii. The Board of Directors of the Corporation comprises of chairman (a Deputy Governor of the Reserve Bank), one officer of the Reserve Bank, one officer of the Central Government, five Directors nominated by the Central Government in consultation with the Reserve Bank, three of whom have special knowledge of

commercial banking, insurance, commerce, industry or finance and two persons having special knowledge in co-operative banking or co-operative movement, four Directors nominated by the Central Government in consultation with the Reserve Bank having special knowledge in accountancy, agriculture, banking, co-operation, economics, law, finance etc.

iii. The Banks covered by the Deposit Insurance Scheme include -1. All commercial banks including branches of foreign banks, Local Area Banks and Regional Rural Banks; 1. Co-operative Banks.

iv. The insurance cover at present is of rupees one lakh per depositor(s) for deposits held in 'same right and in same capacity' in all branches of the bank taken together. (Section 16(1) of DICGC Act). The Corporation can raise this limit.

v. All types of bank deposits except the following are covered under the insurance scheme – 1. Deposits of foreign governments; 2. Deposits of Central/State Governments; 3. Inter-bank deposits; 4. Deposits of State Land Development Banks with State Co-operative Banks; 5. Any amount due on account of and deposit received outside India; 6. Any amount specifically exempted by corporation with the previous approval of RBI.

vi. Corporation has three funds – 1. Deposit Insurance Fund; 2. Credit Guarantee Fund and 3. General Fund.

(b) National Housing Bank (NHB) - NHB was established by the National Housing Bank Act 1987. It is the apex level institution for housing and its entire paid- up capital was contributed by Reserve Bank. The basic function of NHB as defined in the preamble to the National Housing Bank Act 1987 is '… to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto..' NHB has been established to achieve the following objectives –

i. To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

ii. To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.

iii. To augment resources for the sector and channelize them for housing.

iv. To make housing credit more affordable.

v. To regulate activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
vi. To encourage augmentation of supply of buildable and also building materials for housing and to upgrade the housing stock in the country.
vii. To encourage public agencies to emerge as facilitators and suppliers of serviced land and for housing.

(c) Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL) - BRBNMPL was established in 1995 and is responsible for production of bank notes in India. For this purpose, the company manages 2 Presses at Mysore and Salboni with a capacity of 16 billion note pieces per year on a 2- shift basis.

In addition, National Bank for Agriculture and Rural Development (NABARD) is set up by the Government of India in collaboration with Reserve Bank. NABARD is the apex institution looking into the credit requirements of agricultural field and other economic and developmental activities in rural areas. It has been set up with a capital of Rs. 2,000 crore provided by the government of India and the Reserve Bank. NABARD performs following significant functions.

i. Improvement of credit delivery system.
ii. Co-ordination of rural financing activities of all institutions engaged in developmental work.
iii. Preparing rural credit plans for all districts in country.
iv. Promoting research in the field of rural banking, agriculture and rural development.
v. Supervision and monitoring of cooperative banks and regional rural banks.

2.4 MAJOR FUNCTIONS PERFORMED BY RBI

The Reserve Bank is the Central bank and is responsible for looking over the nation's financial sector. Besides performing the regular functions of a Central bank as discussed above, it also undertakes a number of secondary activities aimed at overall betterment of the health of the financial sector in general. Its chief functions are discussed below.

7.4.1 Bank of Issue

Reserve Bank is the note issuing authority of India with authority to issue notes up to the value of rupees ten thousand. It designs, produces and manages the country's currency. This is done mainly by the Department of Currency Management along with the Issue Department in Reserve Bank's regional offices. For this purpose, there are four printing

presses located at Dewas in Madhya Pradesh, Nasik in Maharashtra, Mysore in Karnataka and Salboni in West Bengal. While the first two are owned by Security Printing and Minting Corporation of India, the latter two are owned by Bharatiya Reserve Bank Note Mudran Private Limited. There are also four coin mints located at Mumbai, Kolkata, Uttar Pradesh and Hyderabad.

Reserve Bank is also responsible for addressing the security aspects of currency and looking into ways to reduce counterfeiting of notes and currency. This is done by public awareness campaigns, installing note sorting machines and regular upgradation in bank note security features. As part of public awareness campaigns, Reserve Bank has come up with a 'Clean Note Policy' propagating- (i) Ways to handle notes (no stapling, writing, excessive folding etc.); (ii) Removal of soiled notes and (iii) Exchange facility for torn, mutilated or defective notes.

In this regard certain key provisions of the Reserve Bank of India Act 1934 are discussed herein under:

- Section 22 provides that the Bank has the sole right to issue bank notes in India. Thus all the notes in India are from Reserve Bank, carrying its seal.
- Section 23 provides that the issue of bank notes is to be conducted by Bank in an Issue Department, which shall be separate and wholly distinct from the Banking Department. The assets of the Issue Department will not be subject to any liabilities other than the liabilities of the Issue Department. The Issue Department will not issue bank notes to the Bank Department or to any other person except in exchange for other bank notes or for such coin, bullion or securities as will be permitted to be part of Reserve.
- Section 24 provides for the denomination of notes which can be issued. It provides that the bank notes shall be of the denominational value of two rupees, five rupees, ten rupees, twenty rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees, five thousand rupees and ten thousand rupees or any denominational value not exceeding ten thousand as the central government may specify.
- Section 25 provides for the form of bank notes and specifies that the design, form and material of bank notes shall be such as is approved by the Central government on the basis of the recommendations made by Central Board.

- Section 25, while speaking about the legal tender character of notes provides that every bank note shall be legal tender at any place in India in payment or on account for the amount expressed therein.
- Section 27 bars Reserve Bank from re-issuing bank notes which are torn, defaced or excessively soiled. As per Section 28, no person is entitled to recover from the Central Government or the Bank, value of any lost, stolen, mutilated or imperfect currency note of the Government of India or bank note.
- As per section 29, Reserve Bank is exempted from payment of stamp duty under the Indian Stamp Act 1899 in respect of bank notes issued by it.
- Section 34 provides that the liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and bank notes for the time being in circulation.

7.4.2 Banker to the Government

Section 20 of the Reserve Bank of India 1934 imposes an obligation on the Reserve Bank to transact Government business. The Reserve Bank is obliged to undertake the receipts and payments of the Central Government and to carry out the exchange, remittance and other banking operations, including the management of the public debt of the Union. Section 21 of the Act further provides that the Reserve Bank has the right to transact Government business in India. It provides that the Central Government shall entrust the Reserve Bank with all its money, remittance, exchange and banking transactions in India and will deposit free of interest all its cash balances with the bank. The Central Government will also entrust the Reserve Bank with management of the public debt and issue of any new loans. Section 21A gives Reserve Bank the right to transact State Government transactions. Twenty-three States have entered into such agreements with the Reserve Bank. Two States – Jammu & Kashmir and Sikkim – have agreements with the Reserve Bank only for management of their public debt.

The Principal Accounts of Central as well as State Governments are maintained by the Reserve Bank at its Central Accounts Section, Nagpur. The Public Accounts Departments of RBI and branches of Agency Banks appointed under Section 45 of the RBI Act carry out the Government transactions. At present all the public sector banks and three private sector banks viz. ICICI Bank Ltd., HDFC Bank Ltd. and Axis Bank Ltd. act as Reserve Bank's agents. Only authorized branches of Agency banks can conduct Government business. The Reserve Bank is not entitled to any remuneration for the conduct of ordinary banking

business other than the advantages which may accrue to it from the holding of their cash balances free of obligation to pay interest thereon. Maintenance of such interest-free balances is subject to periodic agreements between the States and the Reserve Bank. The Reserve Bank advises the States about their daily cash balance at the close of each working day. Reserve Bank is also responsible for the investment of a State's surplus fund. Surplus funds of a State are invested in 14 day intermediate Treasury Bill.

Section 17(5) provides that the Ways and Means Advances (WMA) will be provided by the Reserve Bank to States for meeting temporary mismatch in cash flow. Some of the chief features of WMA are:

(a) WMA are repayable within three months from the date of making of advances.
(b) WMA can be of two types- normal and special.
(c) Normal WMA are clean advances.
(d) Special WMA are secured advances and were introduced in 1953. They are secured against Government securities.
(e) Reserve Bank sets the limits for special and normal WMA for each State depending upon a State's holding of Central Government securities.
(f) Limit for WMA of States was fixed for the first time on 1 April 1937. This limit has been subsequently revised after formation of Part B States in 1953.
(g) Amount drawn by a State in excess of WMA is an overdraft and is regulated by the overdraft Regulation Scheme.
(h) WMA overdrafts are monitored by the Internal Debt Management Cell (IDM) of Reserve Bank in association with the Central Accounts Section (CAS), RBI, Nagpur. This is done on a daily basis.
(i) Interest is charged on WMA and overdrafts.

7.4.3 Banker's Bank

Reserve Bank of India is the banker to other banks. All banks have accounts with Reserve Bank similar to the way individuals and other customers have accounts with banks. Banks have to open a non-interest earning current account with the Reserve Bank and have to maintain a minimum balance. These accounts can be opened at each of the regional offices of the Reserve Bank. Reserve Bank as a banker to the banks is responsible for:

(a) Settlement of Inter-Bank Transactions using Real Time Gross Settlement System (RTGS).
(b) Fund Transfer by banks using remittance facilities of Reserve Bank.

(c) Lending to banks as lender of the last resort in case banks are unable to raise short term liquid resources.

(d) Helping banks in maintaining Statutory Reserve Requirements and transaction balance. Reserve Bank's Deposit Accounts Department has a central monitoring system which helps banks to manage their funds, maintaining a balance between surplus and deficit.

(e) Providing short term loans and advances to banks.

2.4.4 Monetary Policy Formulation and Control

Reserve Bank is in-charge of formulating the monetary policy. Monetary policy refers to use of instruments under control of central bank to regulate availability, cost and use of money and credit for achieving specific economic objectives such as low and stable inflation and promotion of growth by monitoring and analysing movement of a number of indicators such as interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows, fiscal position and output trends. (RBI Doc RBIB140520012).

Monetary policy formulation is done by the Monetary Policy Department with assistance from Financial Markets Department (FMD) which is in-charge of handling the day-to-day liquidity management operations. Assistance is also taken from Technical Advisory Committee on Monetary Policy, pre-policy consultation with bankers, economists, market participants, chambers of commerce and industry, discussion with credit head of banks and feedback from banks and financial institutions.

Reserve Bank issues annual policy statements in April. Three quarterly reviews are published in July, October and January. Three mid-quarter statements are published in September, December and March.

There are several direct and indirect instruments which are used in formulation and implementation of monetary policy (RBI Doc RBIBI 405200212).

A. Direct instruments:
   (i) Cash Reserve Ratio (CRR) - Share of net demand and time liabilities required to be maintained by banks as cash balance with the Reserve Bank.
   (ii) Statutory Liquidity Ratio (SLR) - Share of net demand and time liabilities required to be maintained by banks in safe and liquid assets.
   (iii) Sector-specific refinance facilities provided to banks.
B. Indirect instruments:
(i) Liquidity Adjustment Facility (LAF) - Infusion or absorption of liquidity through repo, reverse repo, auction operations, use of government securities as collateral.

(ii) Repo/Reverse Repo Rate - Section 45U (c) and (d) of Reserve Bank of India Act 1934 define 'repo' and 'reverse repo' respectively. Repo is defined as an instrument for borrowing funds by selling securities with an agreement to repurchase securities on a mutually agreed future date at an agreed price which includes interest for funds borrowed. Reverse repo refers to an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for funds lent. Increase and decrease of these rates are aimed at liquidity injection and liquidity absorption and is useful for determining short term money market interest rates.

(iii) Open Market Operations (OMO) - It refers to sale/purchase of government securities to determine liquidity over medium term.

(iv) Marginal Standing Facility (MSF) - Under this facility, Scheduled commercial banks can borrow over-night to deal with unexpected liquidity problems.

(v) Bank Rate - Rate at which Reserve Bank buys or rediscounts bills of exchange or other commercial papers reflecting monetary policy on a medium term basis.

(vi) Market Stabilisation Scheme (MSS) - It refers to liquidity absorption through sale of short- dated government securities and treasury bills.

7.4.5 Regulator of Banking System and Payment and Settlement System

Reserve Bank is the regulator of the banking system and is responsible for protecting the interests of the depositors besides overseeing orderly development of banking sector. Reserve Bank is responsible for licensing of banks and regulates interest rates, capital requirement norms, priority sector lending, asset classification, exposure limits, income recognition etc. The role of Reserve Bank as regulator of the Banking System is performed by different departments. All commercial banks are regulated by the Department of Banking Operations and Development. Urban co-operative banks are regulated by the Urban Banks Department. The rural banks and co-operative banks are regulated by NABARD and Non-Banking Financial Companies are regulated by Department of Non-Banking Supervision.

As the regulator of Payment and Settlement System under the Payment and Settlement Systems Act 2007, Reserve Bank regulates all forms of payment such as money, cheques, electronic modes etc. The task of RBI is to ensure orderly functioning and development of the system. This work is assigned to the Department of Payment and Settlement Systems and the Department of Information Technology. Two systems used by bank for payment are the –Retail payment system and the large value system. Large value

system includes the Real Time Gross Settlement System (RTGS), Securities Settlement System and Foreign Exchange Clearing.

7.4.6 Custodian of Foreign Exchange Control

The Reserve Bank has a very important role in the regulation and development of foreign exchange market. Reserve Bank administers the Foreign Exchange management Act 1999. As part of foreign exchange control, Reserve Bank is specifically entrusted with the task of - (i) Regulation of domestic foreign exchange market. (ii) Regulation and management of foreign currency assets and gold reserves of country. (iii) Undertaking efforts aimed at development of foreign exchange market.

There are three Departments playing vital role in this regard. They are (a) Foreign Exchange Department (FED); (b) Financial Market's Department (FMD) and (c) Department of External Investments and Operations (DEIO). The vision statement of Foreign Exchange Department provides that its vision is to –

i. Evolve appropriate environment in discharging the basic objective of the Foreign Exchange Management Act 1999.
ii. Facilitate external trade and payments and promote orderly development and maintenance markets in India.
iii. Frame prompt and pro-active policy responses, as part of active capital account management.

FMD is responsible for undertaking sales/purchases of foreign currency for the purpose of regulation of supply of foreign currency. DEIO is in-charge of investing India's foreign exchange reserves while being guided by the principle of safety, liquidity and return.

7.4.7 Other Promotional Functions

Besides the above mentioned functions, Reserve Bank undertakes a number of other developmental and promotional activities. Reserve Bank has taken a number of efforts to direct credit to neglected sectors such as agriculture. A number of schemes have been implemented for financial inclusion. Besides these, Lead Bank Scheme has been launched wherein a commercial bank is chosen as the lead bank in each district and is entrusted with the responsibility of banking development in the district. Reserve Bank has taken a number of efforts for increasing financial literacy. For this purpose, information has been uploaded on websites and Reserve Bank on regular basis issues a number of brochures, advertisements in different languages. Reserve Bank has also established a number of institutions like Deposit Insurance and Credit Guarantee Corporation for protecting interests of depositors, National

Bank for Agriculture and Rural Development for promotion of rural and agricultural credit etc.

7.5 SUMMARY

Central bank is the highest monetary institution of a country. It is the apex body and as such is responsible for formulating, implementing and monitoring the financial policy of a country. In India, Reserve Bank of India is the central bank. The Reserve Bank as Central Bank of the country has a number of important functions. It is the chief monetary authority of the country and is entrusted with the task of formulating and implementing the monetary policy of the country. It is also responsible for maintaining price stability and credit flow to productive sectors. As regulator of the financial system, it is in-charge of the over- all smooth running of the banking and financial systems keeping in mind the interest of the depositors and the public. Reserve Bank also facilitates external trade and payment and is also responsible for maintenance of foreign exchange market in India. It is the issuer of currency and destroys currency and coins, which are not fit for circulation. It is also a banker to the banks and all banks maintain accounts with it. It also functions as banker to the government.

7.6 KEYWORDS

1. Central Bank
2. Reserve Bank
3. Organizational Structure
4. Banker's Bank
5. Lender of Last Resort
6. Foreign Exchange Control
7. Monetary Policy
8. Payment and Settlement System
9. Bank of Issue
10. Banker to Government.

7.7 SELF ASSESSMENT QUESTIONS

1. What do you mean by Central Bank? What are the basic functions performed by the Central Bank?

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2. Discuss the organizational structure of Reserve Bank.

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3. Elaborate upon the role of Reserve Bank as Banker's Bank and Banker to the Government.

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4. Discuss the role of Reserve Bank in the formulation of monetary policy.

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5. How does the Reserve Bank function as the custodian of foreign exchange?

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7.8 REFERENCES

1. M. J. Aslam, *Legal Aspects of Bank Lending*, Hyderabad: Asia Law House, 2010.
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UNIT-8 LAW OF BANKING REGULATION

Structure:

8.0 Objectives

8.1 Introduction

8.2 Social control of banking institutions and the mechanism thereto

8.3 Licensing of banking activities

8.4 Minimum paid up capital and reserves

8.5 Reserves

8.6 Summary

8.7 Key words

8.8 Self Assessment Questions

8.9 References

8.0 OBJECTIVES

- To know the control of Reserve Bank over Banking Sector.
- To able to understand the specific provisions of Reserve Bank's control over banks in case of licensing, paid up capital and reserves etc.

8.1 INTRODUCTION

The regulation of banking institutions occupies a significant place in the social priority of all the countries in the world, since the banks are the custodian of societal savings. Just like the commercial establishments, banks are also subject to norms relating to licensing, management, amalgamation, winding up etc. In light of the above factors, this Unit discusses various aspects of banking regulation by the Reserve Bank. In India, the Reserve Bank is in-charge of issue of license to banking companies, issue of guidelines on minimum paid up capital and reserves, and control over managerial organs. Reserve Bank also has a very key role to play in case of amalgamation and reconstruction of banking companies. The Unit also discusses Reserve Bank's control over accounts and audit and winding up.

8.2 SOCIAL CONTROL OF BANKING INSTITUTIONS AND THE MECHANISM THERETO

The banks are custodians of savings. They are the most important institutions to provide credit. The primary function of banks is to mobilize deposits and advance them as credits. The way credit is distributed determines growth and development of individual sectors. There are certain sectors with greater credit requirement over other sectors. Some examples of such sectors are agriculture, small–scale industry, animal husbandry etc. Presently, these sectors are defined as priority sectors and these sectors are given preferential treatment.

Post independence, it was gradually realized that the distribution of credit was limited to few industries and some marked sectors. Other sectors, which were in need of credit were neglected. To tide over the elitist developments, it was thought imperative to have governmental control of banks. For this purpose, the Banking Laws (Amendment) Act was passed in December 1968, which came into force on 1 February 1969. This Act provided the scheme of 'social control' over banks. The Act nationalized fourteen banks. This was followed by The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance 1980 (issued on 15 April 1980) nationalizing six more commercial banks.

In *Rustom Cavasji Cooper and T.M. Gurubaxani* v. *Union of India* [AIR 1970 SC 564], Court while deciding upon the legality of the provisions of the Banking Companies

(Acquisition and Transfer of Undertakings) Act 1969 held that the legislative entry in List I of the Seventh Schedule of the Constitution is 'Banking' and not 'Banker' or 'Banks'. Inclusion of power to legislate in respect of all commercial activities which a banker is competent to engage in would lead to 're-writing' the Constitution. The Court further held that the expression 'undertaking' in Section 4 of the Act refers to a going concern with all its rights, liabilities and assets distinct from the various rights and assets which compose it. Power to legislate for acquisition of property in Entry 42, List III includes the power to legislate for acquisition of an undertaking. As regards the taking over by State of banking business, the Court held that the provisions of the Act provide for transfer of the undertakings of the named banks and prohibiting those banks from carrying on business of banking. The restrictions imposed have to be considered under Article 19 (1)(f) and Article 19 (1)(g) of the Constitution. Rights provided under Article 19 of the Constitution are not unlimited but are subject to reasonable restrictions. One such restriction is mentioned under Article 19 (6). Again, in *Ashoka Marketing Ltd.* v. *Sahu Jain Services ltd.*, *Pandit K.B. Parsai* v. *Union Bank of India*, and *Benett Coleman & Co. Ltd.* v. *Life Insurance Corporation* [AIR 1991 SC 855], Court held that as per Section 3 of the Bank Nationalisation Act 1970, nationalised banks are owned by Central Government. Further, under Section 2 e(2)(i) premises belonging to a company incorporated under the Companies Act 1956 in which fifty percent or more of the paid-up capital is held by the Central Government is to be treated as public premises.

8.3 LICENSING OF BANKING ACTIVITIES

Section 22 of the Banking Regulation Act 1949 provides for licensing of banking companies. It provides that no company will carry on banking business in India unless it has a license issued for the purpose by the Reserve Bank. The Reserve Bank is free to issue the license subject to such conditions as it thinks fit to impose. To get license, the company has to apply in writing to the Reserve Bank. For grant of a license, the following conditions must be satisfied:

(a) Company should be in a position to pay its present or future depositors in full as their claims accrue.

(b) Affairs of the company should not be conducted in a manner detrimental to the interests of its present or future depositors.

(c) General character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors.

(d) Company has adequate capital structure and earning prospects.

(e) Public interest will be served by the grant of a license to the company to carry on banking business in India.

(f) Grant of license will not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth.

(g) Any other condition, fulfillment of which is in the opinion of the Reserve Bank necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.

In case the company is incorporated outside India, Reserve Bank can require the company to fulfill all the above mentioned conditions. In addition, such foreign company can be subject other conditions. (a) Carrying on of banking business by such company in India should be in the public interest. (b) Government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in India. (c) Company complies with all the provisions of the Banking Regulation Act 1949 applicable to banking companies incorporated outside India. Reserve Bank can cancel a license granted to a banking company under the two major conditions. First, if the company ceases to carry on banking business in India; or Second, if the company at any time fails to comply with any of the conditions imposed upon it.

Before cancellation of license for non-compliance with any of the conditions, Reserve Bank can grant to the company an opportunity of taking steps for complying with or fulfilling such condition/s. If the Reserve Bank cancels a license, then such company can prefer an appeal to the Central Government within 30 days and the decision of the Central Government would be final in this regard.

The Reserve Bank of India has recently released new guidelines for “Licensing of New Banks in the Private Sector”. Key features of the guidelines are:

(a) Eligible Promoters: Entities / groups in the private sector, entities in public sector and Non-Banking Financial Companies (NBFCs) shall be eligible to set up a bank through a wholly-owned Non-Operative Financial Holding Company (NOFHC).

(b) ‘Fit and Proper’ criteria: Entities / groups should have a past record of sound credentials and integrity. They should be financially sound with a successful track record of 10 years.

(c) Corporate structure of the NOFHC: The NOFHC shall be wholly owned by the Promoter / Promoter Group. The NOFHC shall hold the bank as well as all the other financial services entities of the group.

(d) Minimum voting equity capital requirements for banks and shareholding by NOFHC: The initial minimum paid-up voting equity capital for a bank shall be `5 billion. The NOFHC

shall initially hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of five years and which shall be brought down to 15 per cent within 12 years. The bank shall get its shares listed on the stock exchanges within three years of the commencement of business by the bank.

(e) Regulatory framework: The bank would be governed by the provisions of the relevant Acts, relevant Statutes and the Directives, Prudential regulations and other Guidelines/Instructions issued by Reserve Bank and other regulators. The NOFHC shall be registered as a non-banking finance company (NBFC) with the Reserve Bank and are governed by a separate set of directions issued by Reserve Bank.

(f) Foreign shareholding in the bank: The aggregate non-resident shareholding in the new bank shall not exceed 49% for the first 5 years after which it should be as per the extant policy.

(g) Corporate governance of NOFHC: At least 50% of the Directors of the NOFHC should be independent directors. The corporate structure should not impede effective supervision of the bank and the NOFHC on a consolidated basis by Reserve Bank.

(h) Prudential norms for the NOFHC: The prudential norms are applied to NOFHC both on stand-alone as well as on a consolidated basis and the norms would be on similar lines as that of the bank.

(i) Exposure norms: The NOFHC and the bank shall not have any exposure to the Promoter Group. The bank shall not invest in the equity / debt capital instruments of any financial entity held by the NOFHC.

(j) Business Plan for the bank: The business plan should be realistic and viable and should address how the bank proposes to achieve financial inclusion.

(k) Other conditions for the bank:

- The Board of the bank should have a majority of independent Directors.
- The bank shall open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census)
- The bank shall comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks.
- Banks promoted by groups having 40 per cent or more assets/income from non-financial business will require RBI's prior approval for raising paid-up voting equity capital beyond `10 billion for every block of `5 billion.
- Any non-compliance of terms and conditions would attract penal measures including cancellation of licence of the bank.

(l) Additional conditions for NBFCs promoting / converting into a bank: Existing NBFCs, if considered eligible, may be permitted to promote a new bank or convert themselves into banks.

8.4 MINIMUM PAID UP CAPITAL AND RESERVES

Reserve Bank in February 2013 has come up with fresh guidelines on minimum paid up capital requirements. As per the guidelines, the initial minimum paid-up voting equity capital for a bank shall be `5 billion. Any additional voting equity capital to be brought in will depend on the business plan of the Promoters. Non-Operative Financial Holding Company (NOFHC) shall hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of five years from the date of commencement of business of the bank. Bank has to maintain a minimum capital adequacy ratio of 13 per cent of its risk weighted assets (RWA) for a minimum period of 3 years after the commencement of its operations subject to any higher percentage as may be prescribed by RBI from time to time. On a consolidated basis, the NOFHC and the entities held by it shall maintain a minimum capital adequacy of 13 per cent of its consolidated RWA for a minimum period of 3 years.

8.5 RESERVES

Banks have to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). Cash Reserve Ratio is the amount of funds that all Scheduled Commercial Banks (SCB) excluding Regional Rural Banks (RRB) are required to maintain without any floor or ceiling rate with Reserve Bank with reference to their total net Demand and Time Liabilities (DTL) to ensure the liquidity and solvency of Banks. The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio. Present CRR and SLR rates are as follows:

Cash Reserve Ratio (CRR)	**4.00% (w.e.f. 09/02/2013) (announced on 29/01/2013)**	**Decreased from 4.25%which was continuing since 30/10/2012**

Statutory Liquidity Ratio (SLR)	**23%(w.e.f. 11/08/2012) (announced on 31/07/2012)**	**Decreased from 24% which was continuing since 18/12/2010**

8.6 SUMMARY

Reserve Bank has very extensive power of control over banks. Reserve Bank regulates almost every aspect of banking sector. Section 22 of the Banking Regulation Act 1949 provides for licensing of banking companies. It provides that no company will carry on banking business in India unless it has a license issued for the purpose by the Reserve Bank. Reserve Bank also prescribes guidelines on minimum paid up capital requirements. Reserve Bank has authority to regulate managerial and other employees of bank under the Banking Regulation Act 1949. In case of amalgamation, scheme has to be sanctioned by Reserve Bank. Section 29 onwards of the Banking Regulation Act 1949 provides for the Reserve Banks regulatory power over the accounts of a bank. Section 35A provides for the power of the Reserve Bank to give directions. Such directions can be issued in public interest or in the interest of banking policy or to prevent the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors or to secure the proper management of a banking company. Banking companies are bound to comply with such directions.

8.7 KEY WORDS

1. Licensing
2. Amalgamation
3. Winding Up
4. Paid Up Capital
5. Reserves
6. Cash Reserve Ratio

8.8 SELF ASSESSMENT QUESTIONS

1. What is meant by social control of banks?

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2. Discuss the role of Reserve bank with reference to the following –

(a) Licensing of Banks.

(b) Reserve.

(c) Minimum Paid – Up Capital.

8.9 REFERENCES

1. M. J. Aslam, *Legal Aspects of Bank Lending*, Hyderabad: Asia Law House, 2010.
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UNIT-9 POWER OF RBI

Structure:

9.0 Objectives
9.1 Introduction
9.2 Regulation and control over the managerial organs
9.3 Control over amalgamation and schemes of reconstruction
9.4 Control over accounts and audit
9.5 Other powers of reserve bank
9.6 Winding- up of banking companies
9.7 Summary
9.8 Key words
9.9 Self Assessment Questions
9.10 References

9.0 OBJECTIVES

- To able to know how the Reserve Bank has the authority to regulate managerial and other employees of the bank.
- To able understand the specific provisions of Reserve Bank's control over banks in case of amalgamation, winding up, control over accounts and audit etc.

9.1 INTRODUCTION

The **Reserve Bank of India** is India's Central Banking Institution, which controls the Monetary Policy of the Indian Rupee. It commenced its operations on 1 April 1935 during the British Rule in accordance with the provisions of the Reserve Bank of India Act, 1934. The original share capital was divided into shares of 100 each fully paid, which were initially owned entirely by private shareholders. Following India's independence on 15 - August - 1947, the RBI was nationalised in the year of 1 January 1949.

The RBI plays an important part in the Development Strategy of the Government of India. It is a member bank of the Asian Clearing Union. The general superintendence and direction of the RBI is entrusted with the 21-member Central Board of Directors: the Governor (Dr. Raghuram Rajan), 4 Deputy Governors, 2 Finance Ministry representatives, 10 government-nominated directors to represent important elements from India's economy, and 4 directors to represent local boards headquartered at Mumbai, Kolkata, Chennai and New Delhi. Each of these local boards consists of 5 members who represent regional interests, and the interests of co-operative and indigenous banks.

9.2 REGULATION AND CONTROL OVER THE MANAGERIAL ORGANS

Reserve Bank has the authority to regulate managerial and other employees of the bank. Section 36AA of the Banking Regulation Act 1949 provides for the power of the Reserve Bank to remove managerial and other persons from office. It provides that if the Reserve Bank is satisfied that it is necessary in public interest or for preventing affairs of a banking company from being conducted in a manner detrimental to interests of depositors or for securing proper management of any banking company, it can remove from office any chairman, director, chief executive officer or other officer or employee of a banking company. Before passing such an order, a reasonable opportunity of making a representation against the proposed order should be given. Appeal can be preferred against such an order to the Central Government within thirty days of communication of the order. The chairman, director or chief executive officer or other officer or employee of a banking company against whom such an order is made will cease to be concerned with or take part in management of

any banking company for the period specified in the order. He will also not be entitled to claim any compensation for the loss or termination of office. Reserve Bank can appoint a suitable person in place of the employee removed from office.

Section 36AB provides for the power of Reserve Bank to appoint additional directors. Such appointment can be for a maximum of three years at a time. Such person appointed will not incur any liability by reason only of his being a director or for anything done or omitted to be done in good faith in the execution of the duties of his office. The additional director shall also not be required to hold qualification shares in the banking company. Section 36AC provides that any appointment or removal made under Section 36AA or Section 36AB would have an overriding effect over any contrary law in force.

9.3 CONTROL OVER AMALGAMATION AND SCHEMES OF RECONSTRUCTION

The expression "amalgamation" is not defined in the Companies Act 1956 or in the Banking Regulation Act 1949. Section 2 (1B) of the Income Tax Act defines "amalgamation" as "Amalgamation", in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company…"

Section 44A of the Banking Regulation Act 1949 stipulates the procedure for amalgamation of banking companies. It provides that for amalgamation of a banking company with another banking company, a scheme containing the terms of such amalgamation should be placed before the shareholders of each of the banking company concerned. Such scheme has to be approved by a resolution passed with two third majority. A share-holder who votes against the scheme of amalgamation is entitled to receive the value of his shares as determined by the Reserve Bank if such scheme is sanctioned by the Reserve Bank. The determination of value of his shares by the Reserve Bank shall be final. After the scheme is approved by the majority of the share-holders, the scheme has to be submitted to the Reserve Bank for sanction. Once it is sanctioned by the Reserve Bank, it is binding on all the banking companies concerned and also on the share-holders thereof. After the scheme of amalgamation is sanctioned by the Reserve Bank, the property of the amalgamated banking company shall be transferred to and become the liability of the banking company. The Reserve Bank in its order of sanction of the scheme can specify a date on which the amalgamated banking company will cease to function and shall stand dissolved. In case of dissolution of a banking company, a copy of the order has to be transmitted to the Registrar

before whom the banking company has been registered. The Registrar on receipt of such an order would strike off the name of the company.

Section 44B provides for restriction on compromise or arrangement between banking company and creditors. It provides that High Court shall not sanction a compromise or arrangement between a banking company and its creditors unless the compromise or arrangement has been certified by the Reserve Bank in writing as not being capable of being worked and as not being detrimental to the interests of the depositors of the banking company. In case such an application is made to the High Court, the High Court can direct the Reserve Bank to make an inquiry into the affairs of the banking company and the Reserve Bank shall make such an inquiry and submit its report to the High Court.

Section 45 provides for the power of the Reserve bank to apply to the Central Government for suspension of business of a banking company and to prepare scheme of reconstitution or amalgamation. It provides that if the Reserve Bank feels it necessary, it can apply to the Central Government for an order of moratorium. The Central Government can make an order of moratorium staying the commencement or continuance of all actions and proceedings against the company for a fixed period of time. The total period of moratorium cannot exceed six months. The banking company shall not make any payment to any depositors or discharge any liabilities or obligations to any other creditors during the period of moratorium.

During the period of moratorium, Reserve Bank can prepare a scheme for the reconstruction of the banking company, or for the amalgamation of the banking company with any other banking institution. Such a scheme can provide

a. For the constitution, name and registered office, the capital, assets, powers, rights, interests, authorities and privileges, liabilities, duties and obligations of the banking company on its reconstruction or of the transferee bank ;
b. change in the Board of directors, or the appointment of a new Board of directors, of the banking company on its reconstruction;
c. alteration of the memorandum and articles of association of the banking company on its reconstruction;
d. reduction of the interest or rights which the members depositors and other creditors have in or against the banking company;
e. Payment to depositors and other creditors in respect of their interest or rights in or against the banking company before its reconstruction or amalgamation;

f. Allotment to the members of the banking company for shares held by them therein before its reconstruction or amalgamation;
g. Continuance of the services of the employees of the banking company in the banking company itself on its reconstruction in the transferee bank

A copy of the scheme prepared by the Reserve Bank should be sent to the banking company and also to the transferee bank. Scheme has to be placed before the Central Government for its sanction. On and from the date of the coming into operation of the scheme, the properties and assets of the banking company shall be transferred to and vest in the transferee bank. Copies of the scheme shall be laid before both the Houses of Parliament after its sanction by the Central Government.

9.4 CONTROL OVER ACCOUNTS AND AUDIT

Sections 29 to 35 of the Banking Regulation Act 1949 provide for the Reserve Bank's regulatory power over the accounts of every bank. Section 29 provides that at the expiration of each calendar year every banking company incorporated in India (in respect of all business transacted by it) and every banking company incorporated outside India (in respect of all business transacted through its branches in India) shall prepare a balance- sheet and profit and loss account as on the last working day of the year. The balance- sheet and profit and loss account shall be signed by the manager or the principal officer of the company. Section 30 of the Act provides that the balance- sheet and profit and loss account prepared in accordance with section 29 shall be audited by a person duly qualified to be an auditor of companies. Also, every banking company has to obtain the previous approval of the Reserve Bank before appointing, re- appointing or removing any auditor or auditors. Reserve Bank can order a special audit of the banking company's accounts under certain circumstances. Such an auditor has to give a report on

(a) Whether or not the information and explanations required by him have been found to be satisfactory;
(b) Whether or not the transactions of the company which have come to his notice have been within the powers of the company;
(c) Whether or not the returns received from branch offices of the company have been found adequate for the purposes of his audit;
(d) Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account;

(e) Any other matter which he considers should be brought to the notice of the share-holders of the company.

Section 31 provides that the accounts and balance- sheet referred to in section 29 together with the auditor's report should be published and furnished as returns to the Reserve Bank within three months from the end of the period to which they refer. Section 32 provides that copies of such accounts and balance- sheet and the auditor's report should be file with the registrar. Banking company incorporated outside India should display a copy of its last audited balance- sheet and profit and loss account prepared under section 29 (Section 33). Reserve Bank can inspect any banking company and its books and accounts under Section 35. Reserve Bank can report the results of the inspection to the Central Government and the Central Government can prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for winding up of the banking company if it feels that the affairs of the banking company are being conducted to the detriment of the depositors. An order for inspection can also be made by the Reserve Bank on the order of the Central Government.

9.5 OTHER POWERS OF RESERVE BANK

Section 35A provides for the power of the Reserve Bank to give directions. This provision confers a blank cheque to the Reserve Bank to exercise its power regarding anything relating to banking sector, of course subject to the requirement of reasonable exercise. Such directions can be issued in public interest or in the interest of banking policy or to prevent the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors or to secure the proper management of a banking company. Banking companies are bound to comply with such directions.

9.6 WINDING- UP OF BANKING COMPANIES

Section 38 onwards of the Banking Regulation Act 1949 provide for winding up of a banking company by court. It provides that Court shall order the winding up of a banking company if the banking company is unable to pay its debts or if an application for its winding up is made by the Reserve Bank under Section 134 or under Section 38.

Reserve Bank can make an application for winding up of a banking company, if the banking company –

(a) Fails to comply with the requirements specified in Section 11 of the Banking Regulation Act 1949 ; or

(b) Has become disentitled to carry on banking business in India; or

(c) Banking Company is prohibited from receiving fresh deposits ; or

(d) Banking Company has failed to comply with any requirements provided under the Banking Regulation Act 1949 other than the requirements laid down in Section 11; or

(e) A compromise or arrangement sanctioned by a court in respect of a banking company cannot be worked satisfactorily; or

(f) The returns, statements or information furnished to Reserve Bank under the provisions of the Banking Regulation Act 1949 disclose that the banking company is unable to pay its debts ; or

(g) Continuance of the banking company is prejudicial to the interests of the depositors.

Where the Reserve Bank makes an application for winding up of a banking company, the Reserve Bank, the State Bank of India or the Deposit Insurance Bureau or any other person from the panel of trustees of the Court shall be appointed as trustee by the Court in consultation with the Reserve Bank of India (Section 39).

Such trustee shall submit a preliminary report to the Court giving information regarding the amount of assets which are in cash and under his control and the amount of assets which are likely to be collected in cash within a period of two months to discharge the liabilities and obligations of the banking company towards depositors and other creditors (Section 41). Further, trustee has to make all efforts to dispose of the assets of the banking company and collect cash to dispose off the liability and obligations of the banking company. Trustee shall give a notice to preferential claimants and secured and unsecured creditors to send to the trustee, a statement of the amount claimed by them (Section 41A). This statement has to be sent within one month of the date of service of the notice. In case such a statement is not submitted to the trustee, the debt will not be treated to be paid in priority to all other debts but will be treated as an ordinary debt due by the banking company.

Section 43 provides that in proceedings for winding up of the banking company, the claim filed by the depositor of the banking company will be deemed proved unless trustee proves otherwise. Preferential payment will be made to the depositors in proceedings for winding up of a banking company under Section 530 of the Companies Act 1956. Section 44 of Banking Regulation Act 1949 provides for the powers of High Court in case of voluntary winding up. It provides that, before a banking company is voluntarily wound up, the Reserve bank has to certify in writing that the company is able to pay in full all its debts to its creditors as they accrue. High Court can order that the voluntary winding up will continue subject to court supervision. High Court can on its own motion order the winding up of a banking company if during any stage of voluntary winding up of the banking company, the

company is not able to meet its debts as they accrue or if it appears to the Court that voluntary winding up or winding up subject to supervision of court cannot be continued without detriment to the interests of the depositors.

Section 45B gives High Court the power to decide all claims in respect of banking companies which are being wound up. In case an order of winding up is made, any suit or legal proceeding pending in any court shall be transferred to the High Court deciding upon or under whose supervision the winding up of the banking company is being carried on (Section 45C). Section 45D provides for settlement of debtors. For this purpose, the official liquidator would file a list of debtors and the High Court would make an order settling the list of debtors. High Court can pass an order for payment of any amount due by each debtor along with any other reliefs it may consider necessary. For every such order made, High Court would issue a certificate wherein the reliefs granted are specified along with the names and description of the parties against whom such reliefs have been granted. High Court shall also have the power to sanction a compromise in respect of any debt and to order payment of any debt by installments.

High Court under Section 45E can at any time after a winding up order has been made, make a call on and order payment by any contributory if such contributory has been placed on the list of contributories by the official liquidator and has not disputed his liability. Section 45F provides a rule of evidence. It provides that entries in the books of accounts or other documents of a banking company shall be admitted in evidence in all legal proceedings. High Court under Section 45G can order for public examination of the director or auditor of the banking company. The official liquidator will take part in such examination. Any creditor or contributory can also take part in such examination. If the High Court, upon examination, feels that the director or the auditor is not fit to be the director or auditor of the banking company, it can make an order that such person cannot be the director or auditor of any company for any period specified in the order. The said period cannot exceed five years.

Section 45H contains special provisions for assessing damages against delinquent directors and others. Every director or other officer of a banking company, which is being wound up, has a duty to assist the official liquidator in realization and distribution of the property of a banking company under Section 45I. Section 45J is a very vital provision. It gives High Court the power to take cognizance and try in a summary manner, any offence alleged to have been committed by any person involved with the banking company in relation to its winding up. Reserve Bank under Section 45P can tender advice in winding up proceedings. Reserve Bank also has the power to inspect the books and accounts of the

banking company which is being wound up, either upon the directions of the Union Government or upon the directions of the High Court. In addition, the Reserve Bank can ask the trustee of a banking company for any statement or information relating to the winding up of the banking company under Section 45R.

9.7 SUMMARY

In every country there is one organization which works as the central bank. The function of the central bank of a country is to control and monitor the banking and financial system of the country. In India, the Reserve Bank of India (RBI) is the Central Bank. The RBI was established in 1935. It was nationalised in 1949. The RBI plays role of regulator of the banking system in India. The Banking Regulation Act 1949 and the RBI Act 1953 has given the RBI the power to regulate the banking system. The RBI has different functions in different roles. Below, we share and discuss some of the functions of the RBI.

RBI is the Regulator of Financial System

The RBI regulates the Indian banking and financial system by issuing broad guidelines and instructions. The objectives of these regulations include:

- Controlling money supply in the system,
- Monitoring different key indicators like GDP and inflation,
- Maintaining people's confidence in the banking and financial system, and
- Providing different tools for customers' help, such as acting as the "Banking Ombudsman."

RBI is the Issuer of Monetary Policy

The RBI formulates monetary policy twice a year. It reviews the policy every quarter as well. The main objectives of monitoring monetary policy are:

- Inflation control
- Control on bank credit
- Interest rate control

The tools used for implementation of the objectives of monetary policy are:

- Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR),
- Open market operations,
- Different Rates such as repo rate, reverse repo rate, and bank rate.

RBI is the Issuer of Currency

Section 22 of the RBI Act gives authority to the RBI to issue currency notes. The RBI also takes action to control circulation of fake currency.

RBI is the Controller and Supervisor of Banking Systems

The RBI has been assigned the role of controlling and supervising the bank system in India. The RBI is responsible for controlling the overall operations of all banks in India. These banks may be:

- Public sector banks
- Private sector banks
- Foreign banks
- Co-operative banks, or
- Regional rural banks

The control and supervisory roles of the Reserve Bank of India is done through the following:

- **Issue of Licence:** Under the Banking Regulation Act 1949, the RBI has been given powers to grant licenses to commence new banking operations. The RBI also grants licenses to open new branches for existing banks. Under the licensing policy, the RBI provides banking services in areas that do not have this facility.
- **Prudential Norms:** The RBI issues guidelines for credit control and management. The RBI is a member of the Banking Committee on Banking Supervision (BCBS). As such, they are responsible for implementation of international standards of capital adequacy norms and asset classification.
- **Corporate Governance:** The RBI has power to control the appointment of the chairman and directors of banks in India. The RBI has powers to appoint additional directors in banks as well.
- **KYC Norms:** To curb money laundering and prevent the use of the banking system for financial crimes, The RBI has "Know Your Customer" guidelines. Every bank has to ensure KYC norms are applied before allowing someone to open an account.
- **Transparency Norms:** This means that every bank has to disclose their charges for providing services and customers have the right to know these charges.
- **Risk Management:** The RBI provides guidelines to banks for taking the steps that are necessary to mitigate risk. They do this through risk management in basel norms.
- **Audit and Inspection:** The procedure of audit and inspection is controlled by the RBI through off-site and on-site monitoring system. On-site inspection is done by the RBI on the basis of "CAMELS". Capital adequacy; Asset quality; Management; Earning; Liquidity; System and control.
- **Foreign Exchange Control:** The RBI plays a crucial role in foreign exchange transactions. It does due diligence on every foreign transaction, including the inflow

and outflow of foreign exchange. It takes steps to stop the fall in value of the Indian Rupee. The RBI also takes necessary steps to control the current account deficit. They also give support to promote export and the RBI provides a variety of options for NRIs.

- **Development:** Being the banker of the Government of India, the RBI is responsible for implementation of the government's policies related to agriculture and rural development. The RBI also ensures the flow of credit to other priority sectors as well. Section 54 of the RBI gives stress on giving specialized support for rural development. Priority sector lending is also in key focus area of the RBI.

Apart from the above, the RBI publishes periodical review and data related to banking. The role and functions of the RBI cannot be described in a brief write up. The RBI plays a very important role in every aspect related to banking and finance. Finally the control of NBFCs and others in the financial world is also assigned with RBI.

9.8 KEY WORDS

1. Accounts
2. Audit
3. Managerial Organs
4. Social Control
5. Reserve Bank
6. Banking Regulation Act 1949
7. High Court
8. Auditor

9.9 SELF ASSESSMENT QUESTIONS

1. Explain RBI control over banking?

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2. Discuss the role of Reserve bank with reference to the following –

(d) Control over Managerial Organs

(e) Amalgamation

(f) Control over Accounts and Audit.

(g) Winding –Up.

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UNIT-10: NBFCS AND THEIR REGULATION, CONSUMER PROTECTION ACT AND IBA CODE FOR BANKING PRACTICE

Structure:

10.0 Objective
10.1 Introduction
10.2 The concept of non banking financing companies
10.3 The justification for the existence of NBFCS
10.4 The functions permitted to be performed by NBFCS
10.5 The regulation of NBFCS
- 10.5.1 Registration
- 10.5.2 Requirements for Registration
- 10.5.3 Acceptance of Deposit
- 10.5.4 Prudential Regulations Applicable to NBFCs

10.6 Consumer protection act 1986
10.7 IBA code for banking practice
10.8 Summary
10.9 Key words
10.10 Self Assessment Questions
10.11 References

10.0 OBJECTIVES

- To understand the meaning of NBFC's.
- To know the role of NBFCs in the financial sector.
- To able understand the regulation of NBFCs by the Reserve Bank
- To have insight of the Consumer Protection Act 1986

10.1 INTRODUCTION

Non-banking financial companies (NBFCs) are an important segment of Indian financial system. These institutions perform a variety of financial services such as accepting deposits, making loans and advances, leasing, hire purchase, etc. NBFCs raise funds from public and advance loans to various traders, small-scale industries etc. NBFC's provide a wide range of financial products and services. They supplement the banking sector and play an important role in financial sector because of comparative regulatory flexibility in comparison to banks.

10.2 THE CONCEPT OF NON BANKING FINANCING COMPANIES

A Non-Banking Financial Company (NBFC) is-

- A company registered under the Companies Act 1956
- Engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business and chit business.
- Institutions whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property are not NBFCs.
- A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company)[3].

NBFCs are similar to banks in terms of most of their functions. However, they are different in terms of three factors. First, NBFC cannot accept demand deposits; Second, NBFC cannot

[3] Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Asset Financing, Loan Company.

issue cheques drawn on itself; and third, Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs.

There are eight different types of NBFCs. They are:

(a) Asset Finance Company (AFC): Principal business of an AFC is financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipment, moving on own power and general purpose industrial machines.

(b) Investment Company (IC): Principal business of an IC is acquisition of securities and selling them. Thus it acts as financial intermediary in securities.

(c) Loan Company (LC): LC are financial institutions whose principal business is providing of finance whether by making loans or advances or otherwise for any activity other than its own. Asset Finance Company are not included under LC.

(d) Infrastructure Finance Company (IFC): IFC deploys at least 75 per cent of its total assets in infrastructure loans, has a minimum Net Owned Funds of ₹ 300 crore and has a minimum credit rating of 'A'[4]or equivalent and a CRAR of 15%[5].

(e) Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities. It has to fulfill the following conditions:-

i. Not less than 90% of its total assets should be in the form of investment in equity shares, preference shares, debt or loans in group companies;

ii. Investments in equity shares in group companies should constitute not less than 60% of its total assets;

iii. Should not trade in its investments in shares, debt or loans in group companies except through block sale for dilution or disinvestment;

iv. Should not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI Act 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

v. Its asset size should be ₹ 100 crore or above and

vi. It should accept public funds.

[4] Credit rating evaluates the credit worthiness of an entity. It is carried out by a credit rating agency.

[5] CRAR is the acronym for Capital to Risk Weighted Assets Ratio. It is a standard to measure balance sheet strength of banks.

(f) Infrastructure Debt Fund Non- Banking Financial Company (IDF-NBFC): It facilitates flow of long term debt into infrastructure projects and can raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity.

(g) Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): NBFC-MFI should have at least 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

i. Loan should be disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 60,000 or urban and semi-urban household income not exceeding ₹ 1,20,000;

ii. Loan amount should not exceed ₹ 35,000 in the first cycle and ₹ 50,000 in subsequent cycles;

iii. Total indebtedness of the borrower should not exceed ₹ 50,000;

iv. Tenure of the loan should not be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

v. Loan should be extended without collateral;

vi. Aggregate amount of loans, given for income generation should not be less than 75 per cent of the total loans given by the MFIs;

vii. Loan should be repayable on weekly, fortnightly or monthly installments at the choice of the borrower.

(h) Non-Banking Financial Company – Factors (NBFC-Factors): Principal business of NBFC-Factor is factoring. Its financial assets in the factoring business should constitute at least 75 percent of its total assets and income derived from factoring business should not be less than 75 percent of its gross income.

10.3 THE JUSTIFICATION FOR THE EXISTENCE OF NBFCS

NBFCs are similar to banks in various regards but differ in terms of accepting demand deposits, cheque issue, and deposit insurance and so on. Despite these differences, the growth of NBFCs has been phenomenal with NBFCs not lagging behind banks in any regards. Analysis of the performance record of NBFCs over the last five years shows that NBFCs have outshone growth in banks in almost all sectors. NBFCs unlike banks have greater regulatory flexibility. Justifications for having NBFCs are:

(a) NBFCs provide credit to semi-rural and rural India. Traditional banks have poor access to these domains. The poor and the illiterate lack access to banking services.

NBFCs cater to this group. Though they are not banks they provide similar financial services as banks with eased regulatory procedures.

(b) NBFCs have strong customer relationships. Usually there is personal knowledge about the needs and financial health of the customer, and loans and other financial services can be tailor made according to requirement.

(c) NBFCs constitute almost 70% of the microfinance sector. The chief beneficiaries of microfinance sector include marginal farmers, labourers, small entrepreneurs, self-help groups etc. NBFCs have a growing presence in the infrastructure sector which is expected to see future growth.

(d) NBFCs have introduced new products such as vehicle financing, IPO financing, three wheeler financing, insurance advisory etc.

(e) NBFCs provide quick service with individual attention to customers, doing away with regulatory hassles of banks.

10.4 THE FUNCTIONS PERMITTED TO BE PERFORMED BY NBFC'S

NBFCs can perform the following functions:

(a) Business of financing the physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.

(b) Business of acquisition of securities.

(c) Business of providing of finance whether by making loans or advances or otherwise for any activity other than its own.

(d) Business of providing infrastructure loans,

(e) Business of providing loans to micro-finance sector. Such loans have to follow the following criteria:

i. loan should be disbursed to a borrower with a rural household annual income not exceeding ₹60,000 or urban and semi-urban household income not exceeding ₹1,20,000;

ii. loan amount should not exceed ₹ 35,000 in the first cycle and ₹ 50,000 in subsequent cycles;

iii. total indebtedness of borrower should not exceed ₹ 50,000;

iv. tenure of the loan should not be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

v. loan should be extended without collateral;

vi. aggregate amount of loans, given for income generation should not be less than 75 per cent of the total loans given by MFIs;

vii. loan should be repayable on weekly, fortnightly or monthly installments at the choice of the borrower

(f) Business of factoring.

10.5 THE REGULATION OF NBFCS

Reserve Bank of India regulates and supervises Non-Banking Financial Companies by virtue of powers vested in Chapter III B of the Reserve Bank of India Act 1934. The regulatory and supervisory objectives are threefold. First to ensure healthy growth of the financial companies; Second, to ensure that these companies function as a part of the financial system within the policy framework, in such a manner that their existence and functioning do not lead to systemic aberrations; and third, that the quality of surveillance and supervision exercised by the Bank over the NBFCs is sustained by keeping pace with the developments that take place in this sector of the financial system.

Following are the different aspects of regulation of NBFCs.

10.5.1 Registration:

A. Section 45-IA of the RBI Act 1934 provides that no Non-banking Financial company can commence or carry on business of a non-banking financial institution without obtaining a certificate of registration from the Bank and without having a Net Owned Funds of Rs. 25 lakhs (Rupees two crore since April 1999).

B. Certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with Reserve Bank. The list of such exempted NBFCs include Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act 1982, Housing Finance Companies regulated by National Housing Bank, Stock Exchange and a Mutual Benefit company.

10.5.2 Requirements for Registration:

The company intending to register as NBFC should be a company registered under Section 3 of the Companies Act 1956 and doing business in one of the eight areas mentioned earlier. The company should also have a minimum net owned fund of Rs. 2 crore. A company

complying with these two requirements may submit the application along with the requisite documents for NBFC registration.

10.5.3 Acceptance of Deposit:

All NBFCs are not entitled to accept public deposits. Only those NBFCs to which the Bank had given a specific authorisation are allowed to accept/hold public deposits. There is a ceiling on acceptance of Public Deposits by NBFCs authorized to accept deposits.

Important regulations relating to acceptance of deposits by NBFCs are as under:

(a) The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand.

(b) NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.

(c) NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors.

(d) NBFCs (except certain AFCs) should have minimum investment grade credit rating.

(e) The deposits with NBFCs are not insured.

(f) The repayment of deposits by NBFCs is not guaranteed by RBI.

(g) Certain mandatory disclosures are to be made about the company in the Application Form issued by the company soliciting deposits.

The NBFCs accepting public deposits should furnish to Reserve Bank

(a) Audited balance sheet of each financial year and an audited profit and loss account in respect of that year as passed in the annual general meeting together with a copy of the report of the Board of Directors and a copy of the report and the notes on accounts furnished by its Auditors;

(b) Statutory Quarterly Return on deposits - NBS 1;

(c) Certificate from the Auditors that the company is in a position to repay the deposits as and when the claims arise;

(d) Quarterly Return on prudential norms-NBS 2;

(e) Quarterly Return on liquid assets-NBS 3;

(f) Annual return of critical parameters by a rejected company holding public deposits – NBS 4

(g) Half-yearly ALM Returns by companies having public deposits of ₹ 20 crore and above or asset size of ₹ 100 crore and above irrespective of the size of deposits holding

(h) Monthly return on exposure to capital market by deposit taking NBFC with total assets of ₹ 100 crore and above–NBS 6; and

(i) A copy of the Credit Rating obtained once a year

As per Reserve Bank's Directions, overdue interest is payable to depositors in case the company delays repayment of matured deposits, and such interest is payable from the date of receipt of such claim by the company or the date of maturity of the deposit whichever is later, till the date of actual payment.

Nomination facility is available to the depositors of NBFCs. The Rules for nomination facility are provided for in section 45QB of the Reserve Bank of India Act 1934. If an NBFC defaults in repayment of deposit, the depositor can approach Company Law Board or Consumer Forum or file a civil suit in a court of law to recover the deposits. When an NBFC fails to repay any deposit, Company Law Board (CLB) either on its own motion or on an application from the depositor can direct the NBFC to make repayment of such deposit.

10.5.4 Prudential Regulations Applicable to NBFCs:

Reserve Bank has issued detailed directions on prudential norms, vide Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions 1998. The directions interalia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares, loan to value (LTV) ratio for NBFCs predominantly engaged in business of lending against gold jewellery, besides others. Deposit accepting NBFCs have also to comply with the statutory liquidity requirements.

10.6 CONSUMER PROTECTION ACT 1986

Banking services are covered under the Consumer Protection Act. The Act, passed in the year in 1986, protects interests of customers. Preamble to the Act provides that the Act aims to provide better protection of the interests of consumers by establishing consumer councils and other authorities for settling consumers' disputes. The Central Council is established by the Central Government and consists of the Minister in charge of consumer affairs in Central Government (as Chairman) and other official and non-official members. Council is expected to undertake all steps to 'promote and protect' rights of the consumers (Section 6). Few of the specific objects of the Central Council are: (i) to protect consumers from marketing of goods and services hazardous to life and property; (ii) to promote consumer education, redressal against unfair trade practices or restrictive trade practices; and

(iii) to protect right of information of the consumers. Consumers have the right to have full information of the quality, quantity, potency, purity, standard and price of goods and services.

The Act, under Section 7, provides for establishing State Consumer Protection Councils for the same purpose. The Minister in charge of Consumer affairs in the State Government is supposed to act as the Chairman of the State Council. Section 8A provides for establishment of District Consumer Protection Council with the Collector of the district as the Chairman.

As per Section 2 (c) 'complaint' can be made regarding-

a. Unfair trade practice or restrictive trade practices.
b. Defective goods and services.
c. Charging of excess price for goods or services. A price to be excess should exceed that which has been fixed by or under any law for the time being or force or that which has been displayed or that which has been expressly agreed to between the parties.
d. Goods contravening any safety standards.

'Consumer' under Section 2(d) includes any person who buys goods for consideration. It is immaterial whether the payment has been done or is deferred. Also, the definition incorporates both full and part payment. Obtaining goods for resale or commercial purposes is not protected under the Act. Availing services is also included within the ambit of the Act. As regards services, the conditions imposed under the Act are similar to those for goods. Similarly, availing or hiring services for commercial purposes has been excluded from the definition of 'consumer'. 'Service' under Section 2(o) has been defined as any service which is made available to users for a charge and are not in the nature of being under a contract of personal service. It specifically includes banking, financing, insurance, transport, processing, energy supply, electrical supply, boarding and lodging services, construction, entertainment, news and amusement. The list of services is not exhaustive. In *Consumer Unity and Trust Society* v. *Chairman and MD, Bank of Baroda* [1995 ISJ (Banking) 404], Court while deciding the liability of the bank rendering service within the meaning of clause (g) of section 2 of the Consumer Protection Act 1986 for loss of service due to illegal strike by its employee held that there was no deficiency of service as there was no failure on part of the bank to function rather the employees physically prevented the bank from functioning.

The Act provides for establishment of Consumer Disputes Redressal Agencies. The structure provided under the Act is three-fold- Centre, State and District. National Consumer Disputes Redressal Commission has been established by the Central Government. State

Governments have to establish the State Commission at the State level and 'District Forum' in each district. Under Section 14, the District Forum has the power to issue orders for removing the defect or replace the defective goods. Complainant can be granted the return of the price/charges and may also be provided with the compensation. District forum can grant punitive damages in appropriate cases. The manufacturer can also be asked to cease manufacture of any hazardous goods or from offering any hazardous services. In *Union Bank of India* v. *Seppo Rally OY* [(2000) 99 Comp Cas 490], Court held that the provisions of Section 14 (1)(d) of the 1986 Act, which speaks about compensation for negligence, are applicable if damages are claimed for negligence of the bank and the loss has been caused to the person claiming it from negligence. Mere loss or injury without any negligence on part of the bank is not covered under this section.

Section 15 provides that an appeal from District Forum can be made to State Commission. Limitation period provided in this regard is thirty days. Limitation period can be relaxed in appropriate cases if the State Commission finds that there was sufficient cause for not filing within the period. State Commission also has jurisdiction in case the value of the goods or services (and compensation if claimed) exceeds rupees twenty lakhs but does not exceed one crore rupees. Appeals from State Commission can be made to National Commission within a period of thirty days. National Commission has original jurisdiction in complaints where the value of the goods or services and compensation exceeds one crore rupees. Appeals against any order of the National Commission can be made to the Supreme Court within thirty days from the date of order. Section 24A provides the limitation period of two years for filing a complaint before the District Forum, State Commission or the National Commission.

10.7 IBA CODE FOR BANKING PRACTICE

Indian Bank's Association has issued the IBA Code for Banking Practice. It is a non-statutory code, which the Banks comply on a voluntary basis. The Code, made effective from 1 September 1999 and revised every three years, covers – (i) Banking Services such as current accounts, savings account, other deposit accounts, loans and overdrafts. (ii) Relation between banks and their customers.

Few of the key guidelines provided to the banks under the Code are:-

(a) Banks have to be fair and reasonable in all their transactions. For this purpose, banks have to desist from following any unethical consumer practice. The products and

services offered by banks have to be in compliance with the relevant laws passed by different concerned regulatory authorities.

(b) Banks have to explain the advantages and charges associated with Credit Cards.

(c) Consumer complaints have to be solved quickly, efficiently and in a friendly manner.

(d) Banks are to display the Code on their website. If customer demands, banks have to make available copies of the same. This has been done to ensure due publicity to the code.

(e) Banks have to help customers to select the right products and services according to their needs.

(f) Change in tariff (interest rate or other fees/charges) on credit card has to be informed to the customer.

(g) Banks have been prescribed a number of marketing ethics. This includes both regulations for field personnel and telemarketing.

(h) Credit card should be sent by Bank via courier/ post at the mailing address mentioned by the Customer. PIN (Personal Identification Number) has to be sent to the customer separately.

(i) Banks are supposed to keep all personal information of customers confidential.

(j) Customers must be given sufficient notice regarding the dues payable by them. Bank staff/agents are dictated by Model Code for Collection of Dues and Repossession of Security (issued by Indian Banks Association).

(k) Banks should have a Grievance Redressal Cell. Customer unhappy with bank's services can bring a complaint before such cell/department. Customers have the option of approaching the Banking Ombudsman if their grievance is not addressed by the Bank's cell.

(l) Credit cards can be terminated by the customers after giving notice. Credit card can also be terminated by the bank if the customer violates the cardholder agreement issued in this regard.

10.8 SUMMARY

NBFCs are an integral part of Indian financial system. They play a key role in mobilizing deposits and advancing loans besides performing and extending a plethora of financial services. NBFCs cater largely to the untapped segments of Indian economy where presence of banking sector is nil or marginal. They constitute a convenient source of finance and financial services for rural India. However, being mostly not properly regulated, there

have been a number of scams relating to NBFCs prompting Reserve Banks to tighten regulatory provisions surrounding NBFCs. Consumer Protection Act was passed in the year 1986 to deal with consumer complaints for defective goods and services. Banking services are included within the definition of 'services' and banks can be held liable under the Act for deficiency in services. Indian Bank's Association has issued the IBA Code which is a voluntary Code to be followed by banks in their transactions. Issued in concurrence with the Reserve Bank of India, the Code is revised after every three years laying down broad guidelines to be followed by banks in their dealing with customers and amongst banks inter-se.

10.9 KEY WORDS

1. NBFCs
2. Reserve Bank
3. Regulation
4. Prudential Norms
5. Micro- Finance
6. Registration
7. Loan Company
8. Investment Company
9. Justification
10. Consumer Protection Act 1986
11. District Forum
12. State Commission
13. National Commission
14. Deficiency in services
15. Services
16. IBA Code

10.10 SELF ASSESSMENT QUESTIONS

1. What are NBFCs? How do they differ from banks?

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2. Mention the different types of NBFCs.

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3. How does Reserve Bank regulate NBFCs?

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4. What are the different functions, which can be carried out by NBFCs?

....

....

5. Discuss the implications of Consumer Protection Act 1986 on the banking services.

....

....

6. What is IBA Code? What are its key guidelines?

....

....

10.11 REFERENCES

1. M. L. Tannan, *Banking Law and Practice in India*, Nagpur: Wadhwa and Company, 2005.
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BLOCK III

UNIT-11: LAW AND PRACTICE OF NEGOTIABLE INSTRUMENTS

Structure:

11.0 Objectives

11.1 Introduction

11.2 Meaning of negotiable instruments

11.3 Characteristics of a negotiable instrument

11.4 Presumptions as to negotiable instrument

11.5 The need for the existence/advantages of negotiable instruments

11.6 Evolution of negotiable instruments

11.7 Recent and important amendments to the negotiable instruments act 1881

11.8 Expected changes in the negotiable instruments act

11.9 Summary

11.10 Key Words

1.11 Self Assessment Questions

1.12 References

11.0 OBJECTIVES

- To know the meaning and necessity of negotiable instruments.
- To analyse the characteristics of negotiable instruments.
- To have an overview of the law regulating negotiable instruments.

11.1 INTRODUCTION

Every day business activity requires exchange of goods and services. A lot of these transactions are on credit and some of them are both on cash and credit. In all these transactions requirement of cash is on an immediate basis but it is not possible to carry ready cash at all times for the purpose of transacting business. In such cases, it makes sense to have a more convenient method of making payment. One of such modes is negotiable instrument. The word 'negotiable' means transferable and 'instrument' means document. Thus, negotiable instruments are transferable instruments. These are negotiable in the sense that these are easily transferable from one person to another. The negotiable instruments are the part of commercial transactions from time immemorable and they continue to exist in the modern day. There are several customary and other norms developed on the negotiable instruments.

11.2 MEANING OF NEGOTIABLE INSTRUMENTS

According to section 13 of the Negotiable Instruments Act 1881, a negotiable instrument means "promissory note, bill of exchange, or cheque, payable either to order or to bearer". Thus, according to the Negotiable Instruments Act 1881 there are three types of negotiable instruments i.e., promissory note, bill of exchange and cheque. However in practice there are many other documents, which are recognized as negotiable instruments such as hundis, treasury bills, share warrants, etc. Negotiable instrument is a form of contract. The person writing the document indicates a promise to pay and the person who accepts the document does so in exchange for a product or service. This can either be a formal contract or an implied one.

11.3 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT

A negotiable instrument has the following characteristics:

(a) Possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument gives both right to possession and right to property.

(b) A bona fide transferee for value (holder in due course) is not affected by any defect of title. A person who receives a negotiable instrument has a clear and undisputable title to the instrument.
(c) Transferee of the negotiable instrument can sue in his own name, in case of dishonour.
(d) A negotiable instrument can be transferred any number of times till its maturity. ownership is changed by mere delivery (when payable to the bearer) or by valid endorsement and delivery (when payable to order). Also, while transferring a negotiable instrument, it is not required to give a notice to the previous holder.
(e) Holder of the instrument need not give notice of transfer to the party liable to pay.
(f) The time of payment must be certain.
(g) The negotiable instrument must be in writing.
(h) In every negotiable instrument there must be an unconditional order or promise for payment.
(i) Negotiable instrument must involve payment of a certain sum of money only.
(j) Payee must be a certain person. Person in whose favour the instrument is made must be named or described with reasonable certainty.
(k) Delivery of the instrument is essential.
(l) A negotiable instrument must bear the signature of its maker.
(m) Stamping of Bills of Exchange and Promissory Notes is mandatory as per Indian Stamp Act 1899.

11.4 PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENT

Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes and do not have to be proved. These are:

(a) Consideration: Every negotiable instrument is made or drawn for consideration.
(b) Consideration: Every negotiable instrument, when it has been accepted, indorsed, negotiated or transferred, was accepted, indorsed, negotiated or transferred for consideration.
(c) Date: Every negotiable instrument bearing a date was made or drawn on such date.
(d) Time of Acceptance: Every accepted bill of exchange was accepted within a reasonable time after its date and before its maturity.
(e) Time of Transfer: Every transfer of a negotiable instrument was made before its maturity.

(f) Order of Endorsement: Endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

(g) Stamp: A lost promissory note, bill of exchange or cheque was duly stamped.

(h) Holder in Due Course: Holder of a negotiable instrument is a holder in due course. But if the instrument was obtained from its lawful owner by means of an offence or fraud, the holder has to prove that he is a holder in due course.

(i) Proof of protest: In a suit upon an instrument which has been dishonoured, the court shall on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

11.5 THE NEED FOR THEIR EXISTENCE/ADVANTAGES

The negotiable instruments have their own advantages, which have made them to continue even in the modern era of banking. Some of the key advantages are; (i) They are freely transferable; (ii) There is no need to carry cash. Negotiable instruments constitute as a convenient method of carrying out transactions; (iii) Transferee of a negotiable instrument can sue in his own name. No assignment in writing or notice is required; and (iv) Transferee of a negotiable instrument who takes it for a value and in good faith acquires a good title free from defects.

11.6 EVOLUTION OF NEGOTIABLE INSTRUMENTS

Negotiable Instruments Act was enacted in the year 1881. However, even prior to it, a number of payment system representing modern negotiable instruments were in place. Loan deeds prevalent by the name of rnapatra or rnalekhya were in use in ancient India. Rnapatra or inapanna (it was so called during the Buddhist period) contained all vital details and execution of it was witnessed by a respectable person. The loan deed writer had to endorse the deed. The details included in the deed were the name of the debtor and the creditor, amount of loan, rate of interest, time and conditions of repayment. During the Mughal era, loan deeds came to be known as dastawez and were of two types – dastawez-e-indultalab (payable on demand) and dastawez-e-miadl (payable after a stipulated time).

We had instruments similar to bill of exchange in use during the Mauryan period. These instruments known as the adesha were in the nature of an order on a banker to pay the money of the note to a third person. Issue of bill of exchange was common for financing sea borne trade. Traded at high discounts (due to inclusion of insurance premium) these bills were vastly responsible for the success of foreign trade. Barattes (pay orders) similar to

present day drafts or cheques was another instrument to make payment. These Pay orders were issued from the Royal Treasury.

Hundis were a versatile credit instrument widely used in ancient India for borrowing money, as bills of exchange and for transfer of funds from one place to another. Hundis are the only credit instruments which have survived till today. Principally two types of hundis were in circulation- darshani hundi and muddati hundi. Darshani hundi was a demand bill of exchange, payable on presentation. Darshani hundi could again be of four types i.e. Sah-jog (a hundi transferable by endorsement and delivery), Dhanni-jog (a demand bill of exchange payable only to the dhanni, i.e. the payee), Firman-jog (hundis payable to the order of the person named which could be negotiated with a simple or conditional endorsement) and Dekhavanhar (a bearer demand bill of exchange payable to the person presenting it to the drawee corresponding to a conventional bearer cheque). Sah-jog hundi was so named because it was payable only to a Sah (a respectable and prominent person in trade circle). Muddati hundi was a usance bill payable after a certain time/date or on happening of a specified future event. Muddati hundi could again be Sah-jog, Dhanni-jog or Firman-jog. Jokhami hundi, a type of muddati hundi, prevalent even today is a documentary bill of exchange corresponding to the present day bill of exchange. Use of paper money started in the late 18th century and Bank of Hindoostan, the first joint stock bank of India was the first bank to introduce cheques. Inland promissory notes were started in 1827. The holder of these notes also known as Post Bills was to be paid on acceptance of the same after a specified number of days. Used mainly for internal remittances these bills were similar to muddati hundi in all other regards. Buying and selling of bills of exchange became a business operation of the bank from 1939 onwards and was first started by the Bank of Bengal.

Negotiable Instruments Act was enacted in the year 1881 on the lines of the English law. England for that matter itself did not see codification of mercantile law till the late 1880s. Codification of mercantile customs started with France in 1818 and later on the French Commercial Code Model was replicated in other countries. In 1882 the Bills of Exchange Act primarily drawing from the English common law of contracts was passed in England. The task of enactment of a similar law was taken over by the Indian Law Commission which prepared a bill in 1867. The bill did not see the light of the day and in 1879 Mr. Arthur Philips, the then Law Secretary and a member of Calcutta Bar redrafted the bill. The bill was referred to a new Law Commission in 1879 and the recommendations of the Commission were duly incorporated by another Select Committee.

The aim in framing of the law is evident from the words of the Select Committee of 1879 of the Negotiable Instruments Bill which provides, "the effect of the Bill will be to induce the native mercantile community gradually to discard them (local usages) for the corresponding rules contained in the Bill. The desirable uniformity of mercantile usage will thus be brought about without any risk of causing hardship to Native bankers and merchants. How long this change will take, it is of course impossible to prophesy".

Post enactment of the Negotiable Instruments Act 1881, need was felt for having proper cheque clearing system due to the growth in use of cheque. For this purpose, Clearing associations came to be formed in Presidency towns. Clearing house rules were adopted for the first time in 1938 by the Calcutta Clearing Banks' Association which had twenty five members and eight sub-members. Metropolitan Banking Association composed of those Banks who were not covered under the Calcutta Clearing Banks' Association formed the Metropolitan Clearing House in 1939. Later on two more clearing house, Pioneer clearing and Walks Clearing came up. Outside Calcutta, Bombay Clearing House began its operation in Bombay. The Clearing Houses in the Presidency towns were later taken over by the Reserve Bank of India.

11.7 RECENT AND IMPORTANT AMENDMENTS TO THE NEGOTIABLE INSTRUMENTS ACT 1881

A very important amendment was made in the year 1999 whereby Sections 138 to 142 were inserted. Chapter XVII providing for 'Penalties in Case of Dishonour of Certain Cheques for Insufficient Funds in the Accounts" was added via this amendment. Prior to this insertion, dishonour of cheques was treated as an offence punishable under the Indian Penal Code making conviction very difficult as the guilt had to be proved beyond reasonable doubt. The enhanced parameters of burden of proof under criminal law made it easy for people to make mockery of the legal provisions. Section 139 inserted via amendment provides for presumption to be drawn in favour of holder under certain conditions. It provides that unless the contrary is proved, the holder of the cheque is presumed to have received the cheque for the discharge of any debt or other liability. Section 140 provides for the defences which cannot be allowed in any prosecution under section 138. It provides that defence of knowledge or intention of the cheque being dishonoured on presentment cannot be taken. Section 141 provides for the legal course in case the offence is committed by any company while section 142 provides for the norms relating to taking cognizance of the offence. For a

court to take cognizance of an offence punishable under section 138, a complaint has to be made in writing by the payee or the holder in due course of the cheque.

Another very important amendment was done via the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act 2002 by which section 143-147 were inserted. Section 143 applies the provisions of section 262 to 265 CrPC allowing a Judicial Magistrate or Magistrate of the First Class to carry on trial. Procedure for summary trial has been provided including provisions for day to day hearing of case. A time of six months from the date of filing complaint has been fixed for completion of the trial. Magistrate can pass a sentence of imprisonment not exceeding one year or fine not exceeding twice the amount of cheque. The provisions override anything contrary contained in the Cr.P.C.

Dealing with the aim of achieving speedy trial, Section 144 does away with the detailed procedure for service of summon (under Sections 61-90 Cr.P.C). Summons can be served through speed post and notified private couriers. In case there is a refusal to take delivery of the summons, Court can declare that the summons has been duly served. As per section 145, evidence can be given by affidavit and attached with the complaint. If the accused wants to challenge the contents of the affidavit, complainant can be called for examination. Section 146 provides that the Court will presume fact of dishonour, unless and until such fact is disproved from the bank slip. Section 147 makes the offences under the Act compoundable. The Amendment Act has also brought changes in Section 138, 141 and 142 by providing for enhanced punishment. Imprisonment term of one year has been doubled to two year. Immunity from prosecution has been provided to nominee director and time period to issue demand notice to drawer has been extended to 30 days (previously it was 15 days).

11.8 EXPECTED CHANGES IN THE NEGOTIABLE INSTRUMENTS ACT 1881

Discussions are on to restrict banks from accessing courts for cases of cheque bounce in light of the huge pendency of dishonour of cheque cases at present. It is proposed that such cases should be decided through arbitration, conciliation or settlement by Lok Adalats. The proposed amendments based upon the suggestions of an inter-ministerial group (IMG) advocate this change as a way to deal with the huge pendency of cases. Post amendment, parties are expected to have recourse to alternate dispute resolution mechanism similar to that under Section 89 of the Code of Civil Procedure. Court fee is expected to be made Ad-valorem to have a deterring effect on malicious complaints with the cost of litigation being put upon the defaulting party.

11.9 SUMMARY

Negotiable instruments are transferable instruments. These are negotiable in the sense that these are easily transferable from one person to another. According to the Negotiable Instruments Act 1881 there are three types of negotiable instruments i.e., promissory note, bill of exchange and cheque. However there are many other documents which are recognized as negotiable instruments such as hundis, treasury bills, share warrants, etc. Negotiable instruments are preferred as they are freely transferable, making it a very convenient method of carrying out transactions, doing away with the necessity of carrying cash. Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes and do not have to be proved.

Negotiable Instruments Act was enacted in the year 1881. However, even prior to it, a number of payment system representing modern negotiable instruments were in place. Loan deeds prevalent by the name of rnapatra or rnalekhya were in use in ancient India. We had instruments similar to bill of exchange in use during the Mauryan period. These instruments known as the adesha were in the nature of an order on a banker to pay the money of the note to a third person. Hundis were a versatile credit instrument widely used in ancient India for borrowing money, as bills of exchange and for transfer of funds from one place to another. Use of paper money started in the late 18th century and Bank of Hindoostan, the first joint stock bank of India was the first bank to introduce cheques. Inland promissory notes were started in 1827. Negotiable Instruments Act was enacted in the year 1881 on the lines of the English law. Post enactment of the Negotiable Instruments Act 1881, need was felt for having proper cheque clearing system due to the growth in use of cheque. For this purpose, clearing associations came to be formed in Presidency towns. The Clearing Houses in the Presidency towns were later taken over by the Reserve Bank of India.

A very important amendment was made in the year 1999 whereby Sections 138 to 142 were inserted. Chapter XVII providing for ‘Penalties in Case of Dishonour of Certain Cheques For Insufficient Funds in the Accounts” was added via this amendment. Prior to this insertion, dishonour of cheques was treated as an offence punishable under the Indian Penal Code making conviction very difficult as the guilt had to be proved beyond reasonable doubt. The enhanced parameters of burden of proof under criminal law made it easy for people to make mockery of the legal provisions. Another very important amendment was done via the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act 2002 by which section 143-147 were inserted keeping the aim of speedy trial in mind.

Discussions are on to restrict banks from accessing courts for cases of cheque bounce in light of the huge pendency of dishonour of cheque cases at present. It is proposed that such cases should be decided through arbitration, conciliation or settlement by Lok Adalats. The proposed amendments based upon the suggestions of an inter-ministerial group (IMG) advocate this change as a way to deal with the huge pendency of cases.

11.10 KEY WORDS

1. Negotiable instruments
2. Characteristics
3. Presumptions
4. Necessity
5. Advantages of negotiable instruments
6. Holder
7. Bill of exchange
8. Promissory note
9. Cheque
10. Amendment
11. Pendency
12. Arbitration
13. Conciliation
14. Legislative History

11.11 SELF ASSESSMENT QUESTIONS

1. What are negotiable instruments? Why are they necessary?

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....

2. Mention few chief characteristics of negotiable instruments.

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....

3. Mention certain presumptions surrounding negotiable instruments as per the Negotiable Instruments Act 1881.

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4. Write a brief note about the legislative history of the enactment of the Negotiable Instruments Act 1881.

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5. What important changes have been incorporated to the Negotiable Instruments Act via different amendments?

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11.12 REFERENCES

1. M. L. Tannan, *Banking Law and Practice in India*, Nagpur: Wadhwa and Company, 2005.
2. P. K. Srivastava, *Banking Theory and Practice*, 10th edn, Mumbai: Himalaya Publishing House, 2007.
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UNIT-12: NEGOTIABLE INSTRUMENTS – LAW AND PROCEDURE

Structure:

12.0 Objectives

12.1 Introduction

12.2 Promissory notes

12.3 Bills of exchange

12.4 Hundis

12.5 Cheques

12.6 Bank drafts

12.7 Travellor's cheques

12.8. Rights and duties of various parties to these instruments

12.9. Law and procedure of presentment

12.10. Honor and dishonor of negotiable instruments

12.11. Material alterations

12.12. Summary

12.13 Key words

12.14 Self Assessment Questions

12.15 References

12.0 OBJECTIVES

- To know the different negotiable instruments in terms of their features, differences, rights and duties of parties to it, honour and dishonour, material alteration etc.
- To understand the procedure surrounding presentation of negotiable instruments.

12.1 INTRODUCTION

Section 13 of the Negotiable Instruments Act provides that a negotiable instrument is a promissory note, bill of exchange or a cheque payable either to order or to bearer. Thus the statute recognizes three kinds of negotiable instruments. Negotiable instruments recognised by usage or custom include- (i) Hundis (ii) Bearer debentures (iii) Dividend warrants (iv) Bankers draft (v) Circular notes (vi) Share warrants (vii) Railway receipts (viii) Delivery orders. This list is not exclusive and every instrument has to be judged on the basis of its negotiability. This unit would analyse the definition and meaning of different types of negotiable instruments and delves into the norms regulating them.

12.2 PROMISSORY NOTES

Definition

Section 4 of the Negotiable instruments Act defines " Promissory note" as ‘ an instrument in writing (not being a bank- note or a currency- note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument’.

Features

As per this definition, the features of a promissory note are:

(a) A promissory note must be in writing.
(b) It must contain an express undertaking or promise to pay.
(c) The promise to pay must not be conditional.
(d) It should be signed by the maker.
(e) It must contain a promise to pay money only.
(f) The parties to a promissory note, i.e. the maker and the payee must be certain.
(g) The sum payable mentioned must be certain or capable of being made certain.
(h) A promissory note may be payable on demand or after a certain date.

Illustration

Section 4 by way of illustration provides -A signs instruments in the following terms

(a) “I promise to pay B or order ₹500.”

(b) "I acknowledge myself to be indebted to B in ₹ 1, 000 to be paid on demand, for value received."

(c) "Mr. B, O U ₹1, 000."

(d) "I promise to pay B ₹ 500 and all other sums which shall be due to him."

(e) "I promise to pay B ₹ 500, first deducting there out any money which he may owe me."

(f) "I promise to pay B ₹ 500 seven days after my marriage with C."

(g) "I promise to pay B ₹ 500 on D's death, provided D leaves me enough to pay that sum."

(h) "I promise to pay B ₹ 500 and to deliver to him my black horse on 1st January next."

The instruments respectively marked (a) and (b) are promissory notes. The instruments respectively marked (c), (d), (e), (f), (g) and (h) are not promissory notes.

Different Parties to a Promissory Note

The different parties to a Promissory Note are:

Primary parties:

(a) The Maker or Drawer – The person who makes the note and promises to pay the amount stated therein is known as the maker or the drawer

(b) The Payee – The person to whom the amount is payable is known as the payee.

Secondary parties:

(a) The Endorser – The person who endorses the note in favour of another person is known as the endorser.

(b) The Endorsee – The person in whose favour the note is negotiated by endorsement is known as the endorsee.

The following is a format of a promissory note

₹ 10,000/-   Kolkata, 01 May 2013

I, Ram, s/o. Shyam of Mangalore, Karnataka promise to pay Sitaram, s/o. Ramesh Kumar of Kolkata, West-Bengal or order, on demand, the sum of ₹ 10,000/- (Rupees Ten Thousand only) with interest at the rate of 12 percent per annum, for value received.

Sd/- Ram

Stamp

To

Sitaram

Kolkata, West Bengal

12.3 BILLS OF EXCHANGE

Definition

Section 5 of the Negotiable Instruments Act 1881 defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument."

Parties to a bill of exchange

There are three parties involved in a bill of exchange. They are, (i) The Drawer – The person who makes the order for making payment. (ii) The Drawee – The person to whom the order to pay is made. (iii) The Payee – The person to whom the payment is to be made.

In addition, there may be some other key players in bill of exchange. They are;

(a) Acceptor - After drawee of a bill has signed his assent upon the bill or given notice of such signing to the holder or to some person on his behalf, he is called the 'acceptor'.

(b) Holder- A person legally entitled to the possession of the negotiable instrument in his own name and to receive the amount there of, is called a 'holder'. Usually the original payee or the endorsee is the 'Holder'. In case the bill is payable to the bearer, the person in possession of the negotiable instrument is called the 'holder'.

(c) Endorser - When the holder transfers or indorses the instrument to anyone else, the holder is known as the 'Endorser'.

(d) Endorsee- The person to whom the bill is indorsed is called an 'Endorsee'.

(e) Drawee in case of need -When name of any person is given in addition to the name of the drawee to be resorted to in case of need, such a person is called 'drawee in case of need'.

(f) Acceptor for honour --In case the original drawee refuses to accept the bill, any person who is not liable on the bill may accept it with the consent of the holder. Such an acceptor is called 'acceptor for honour'.

Features of a Bill of Exchange

(a) A bill must be in writing, duly signed by its drawer, accepted by its drawee.
(b) It must contain an order to pay.
(c) The order must be unconditional.
(d) The order must be to pay money and money alone.
(e) The sum payable mentioned must be certain or capable of being made certain.
(f) The parties to a bill must be certain.

Liability of the Parties to a bill of exchange

(a) Acceptance of a bill of exchange by a drawee makes the drawee liable to pay the bill either at the place and date fixed for payment, or in case of a demand bill, at a reasonable time.
(b) If a bill is dishonoured by non-payment, the holder may hold the drawer, acceptor and any endorser liable.
(c) The bill should be presented by the holder at a reasonable hour on a business day at the place specified in the bill.
(d) Once payment is made, holder must turn the bill to the acceptor for cancellation.

Following is a format of bill of exchange

₹ 10,000/- New Delhi

02 May 2012

Five months after date pay Tarun or (to his) order the sum of Rupees Ten Thousand only for value received.

To	Accepted	Stamp
Sameer	Sameer	S/d
Address		Rajiv

Types of Bills

Bills can be classified as - (a) Inland and foreign bills; (b) Time and demand bills; (c) Trade and accommodation bills.

Inland and Foreign Bills:

Section 11 and 12 of the Negotiable instruments Act 1881 provide for Inland bill and foreign bills. An inland bill is one which is; (a) Drawn in India on a person residing in India, whether payable in or outside India, or (b) Drawn in India on a person residing outside India but payable in India.

Examples:

i. A bill is drawn in Bangalore on a person in Chennai and is payable in Kolkata.
ii. A bill is drawn in Bangalore on a trader in Singapore and is payable in Delhi.

As per section 12, bills which are not inland are foreign bills. For example, bill drawn in USA and payable in Delhi or a bill drawn in India on a person residing in Tokyo and made payable in Tokyo are foreign bills. Section 132 and 133 of the Negotiable Instruments Act 1881 provide for bills in sets. Foreign bills are usually drawn in sets of three as there are high chances of loss of bills during transit. Each part or set is known as 'via' and to avoid loss in transit are sent via different modes of conveyance on the same day. The parts are numbered and remain payable till others remain unpaid. Once payment is made on one part, the entire bill is exhausted as all the parts together make one bill. Section 132 further provides that acceptance of the bill is to be communicated only on one part. In case different parts of the bill are accepted in favour of different persons, each part is treated as separate bills. As per section 133, between holders in due course of different parts of same bill, the person who first acquires title to any part is entitled to claim the other parts along with the money represented by the bill.

Time and Demand Bill:

Bills payable after a fixed time are known as time bills and bills which are payable on demand are known as 'demand' bill. Since the time bills specify the time, payment becomes due only after the expiry of the period. However, the demand bills are to be paid by the drawee soon after the delivery for payment at any time.

Trade and Accommodation Bill:

Trade bills are those which are drawn and accepted for the purpose of trade transaction. Accommodation bills as the name suggests are not true bills but are made in order to 'accommodate' or assist some-one. Accommodation bill do not prima facie differ from ordinary bills in any regard. Section 43 of Negotiable Instruments Act 1881 provides

that if the accommodated party continues to hold the bill till maturity, accommodating party does not become liable to him for payment. However, the accommodating party will be liable to any subsequent holder for value who is aware of the nature of the bill and non-receipt of full consideration by acceptor. In such cases, the accommodating party has the right to claim compensation from the accommodated party for the amount paid to the holder for value. As per section 59, holder of an accommodation bill after its maturity is in the same position as a holder before its maturity, provided the holder takes it in good faith and for value.

Difference between Promissory Note and bill of exchange

Promissory Note	**Bill of Exchange**
1. It contains an unconditional promise.	1. It contains an unconditional Order.
2. There are two parties – the maker and the payee.	2. There are three parties – drawer, the drawee and the payee.
3. It is made by the debtor.	3. It is made by the creditor.
4. Acceptance is not required.	4. Acceptance by the drawee is a must.
5. The liability of the maker/drawer is primary and absolute.	5. The liability of the maker/drawer is secondary and conditional upon non-payment by the drawee.

12.4 HUNDIS

Negotiable Instruments Act 1881 restricts itself to three specific types of negotiable instruments as discussed above. Hundis are negotiable instruments whose existence is accepted by usage and custom. These are indigenous negotiable instruments and are one of the oldest instruments used for money transfer. Its form is dictated by the local usage. It can be in the form of a bill of exchange or even in the form of a promissory note. There are no strict specifications regarding its form and content. Consequently, depending upon the conditions put, it can be of various types. For example, darshani hundi are those which are payable at sight. These are similar to demand bill. Muddati hundi are payable after a fixed time period and are similar to time bill. Another very famous type of hundi is the Shah Jog Hundi, which is commonly circulated among the traders. Other than these, Nam-jog hundi,

Jawabee hundi, Jokhami hundi, Dhani- jog hundi are some other famous hundis.[*] Hundis are not governed by the Negotiable Instruments Act but in case there are no usages or customary law, court can apply the law as contained in the Act.

12.5 CHEQUES

Section 6 of the Act defines "A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand".

So a cheque is a bill of exchange with two additional features. First that it is always drawn on a specified banker, and secondly, it is always payable on demand. Therefore, a cheque must satisfy all the requirements of a bill of exchange.

Features of the cheque:

(a) The cheque must be in writing and duly signed by the drawer.
(b) The payee is always certain.
(c) It contains an unconditional order.
(d) The amount specified on the cheque must be clearly mentioned both in figures and words.
(e) It is always payable on demand.
(f) Cheque is issued on a specified banker.
(g) The cheque must bear a date.

Parties to a Cheque:

Drawer- The person who draws the cheque.

Drawee - The banker on whom the cheque has been drawn.

Payee - Person entitled to receive the payment of the cheque.

Types of Cheque:

Cheques can be open or crossed and bearer or order cheques. Open cheques are those which can be directly produced at the bank counter for cash. The holder of an open cheque can get cash over it simply by presenting it. The cheque can be passed on to some-one else by signing at the back of it. However, such cheques are not safe from security point of view as it can be easily en-cashed by any one. In contrast, crossed cheques are those over which payment is not receivable over the counter but is credited to the bank account of the payee. A cheque is crossed by drawing two transverse parallel lines across it. Bearer cheques as the name suggests are payable to the bearer or the person who present it for payment. Order

[*] Refer back for further details.

cheques on the other hand are payable only to a particular person. Order cheques can be transferred by the payee by putting his or her signature on the back of the cheque.

Following is a format of a cheque.

………......20.......

Pay……..

……... or Bearer

Rupees……………………………………………

Rs.

....

STATE BANK OF INDIA

Kunjibettu, Udupi - 576003

MSBL/91

6 4 3 2 0 3 1 1 40 0 1 0 5 6 1 0

Differences between cheque and bill of exchange:

Cheque	**Bill of Exchange**
1. It is drawn only on a banker.	1. It can be drawn on any body including a banker
2. The amount is always payable on demand.	2. The amount is payable on demand or after a specified period.
3.It can be crossed to end its negotiability	3. It cannot be crossed.
4. Acceptance is not required.	4. Acceptance is a must.

12.6 BANK DRAFTS

Bank drafts are bill of exchanges payment of which is guaranteed by the issuing bank. These are like cheques paid in advance. Prior to issue of bank draft, there should be sufficient funds in the account. Out of the funds available, bank sets aside fund equivalent to the amount of bank draft. Bank drafts are safer than cheques as there is no danger of cheque bouncing. Bank drafts can be ‘crossed’. Such drafts can only be put in the named person’s bank account. Bank drafts can only be drawn by a bank on another bank. It is not payable to bearer.

Following is a format of bank draft

Corporation Bank

NUJS Campus Branch

No.................... Date....10/05/2013

On demand pay 'SEEDA A/C' or order the sum of rupees three thousand five hundred only for value received.

₹ 3,500/-

Sd. /

Manager

To

NUJS Campus Branch, Kolkata

12.7 TRAVELLOR'S CHEQUES

Traveller's cheques are a convenient mode of carrying cash in the form of pre-printed cheques of various denominations in different currencies. Following are the major features of traveller's cheque.

(a) They are issued over the counter from banks, money changers or travel operators.

(b) For procurement of traveller's cheque, a copy of passport and confirmed air ticket has to be provided.

(c) A person purchasing the cheque has to pay the value of the cheque according to the denomination of the cheque and a fee to be fixed by the issuer. Denomination of the cheque is the cheque's face value i.e., amount specified in a particular currency.

(d) Traveller's cheque can be exchanged for local currency on reaching the destination country.

(e) Traveller's cheque doesn't have expiry date.

Advantages of Travellers' Cheque:

(a) Traveller's cheque is safe and there is no hassle of loss of cheque. In case it is stolen or lost, traveller's cheque can be easily replaced. For this purpose, the date of purchase, serial number of the cheque and identity proof of the person purchasing the cheque has to be provided. Thus it is a back up to cash and card.

(b) Traveller's cheque is very easy and convenient to use. At the time of purchase of cheques, the cheques should be signed at the upper left hand corner and the serial number of the cheques should be noted down. While using a cheque, the person using it has to sign in presence of the acceptor at the lower left hand corner. Further, there is an option of buy-back, under which the unused traveller's cheque can be sold back or can be used later as they are valid forever.

(c) It is widely accepted. Banks, hotels, foreign exchange bureaus etc. freely accept it. Barring the sanction countries i.e., countries which are banned by the UN or US, traveller's cheque is freely accepted worldwide.

(d) There are different kinds of Traveller's cheque and a person can choose according to one's convenience. They are available in different currencies (Australian Dollar, Euro, Pound Sterling, Canadian Dollar, Japanese Yen, US Dollar etc.) and different denominations.

2.8 RIGHTS AND DUTIES OF VARIOUS PARTIES TO THESE INSTRUMENTS

Section 30- 32 and 35-42 of the Negotiable Instruments Act 1881 provides for the duties/liability of various parties to negotiable instruments. What stands as liability for a party to the instrument is right of the other party to the instrument. Section 30 deals with the liability of drawer. Section 31 deals with the liability of drawee of cheque, section 32 provides for the liability of maker of note and acceptor of bill, Section 35 provides for liability of endorser and Section 36 provides for liability of prior parties. These provisions are discussed in detail hereunder:

Liability of Drawer (Section 30)-

Section 30 provides that in case of dishonor by the drawee or acceptor of a bill of exchange or cheque, the drawer of a bill of exchange or cheque is bound to compensate the holder. For the drawer to be liable, due notice has to be given or received by the drawer. The requirement of notice of dishonor is done away with in case of accommodation bill.

Liability of Drawee of Cheque (Section 31)-

Drawee of a cheque is bound to make payment upon the cheque. For the drawee to be liable, the drawer should have sufficient funds in his account and the funds should be in such

condition that they can be applied for the payment of the cheque (not being under some legal obligation such as lien etc.). Further, the cheque should be presented during regular banking hours, on or after the date on which it is made payable. In case of default by the drawee in making payment, the drawee is liable to compensate the drawer for loss or damage caused by such default.

Liability of Maker of Promissory Note and Acceptor of Bill of Exchange (Section 32)-

Maker of Promissory Note and acceptor of bill of exchange are absolutely and unconditionally liable to make payment of the amount of the bill or note upon maturity to the party named in the instrument. Liability continues to persist if the payment is made to any person other than the one named in the instrument or is made at any time before maturity. The liability under this section can be dispensed with by the consent of the parties. Parties are free to provide for a contrary arrangement.

Section 41 provides that acceptor of an endorsed bill of exchange is not relieved from his liability by reason of such endorsement being forged, if he knew or had reason to believe the endorsement to be forged at the time of acceptance of the bill. Further, an acceptor of a bill of exchange is also liable in a bill drawn in a fictitious name.

Liability of Endorser (Section 35) –

Section 35 provides for the liability of an endorser. Every endorser is liable to the parties who come subsequent to him. Section 88 provides that an endorser is bound by his endorsement not withstanding any previous alteration of the instrument. For the endorser to be liable, the following conditions must be fulfilled:

(a) Endorser endorses and delivers a negotiable instrument before maturity.
(b) The instrument is dishonoured by the drawee, acceptor or maker.
(c) The endorser has not expressly excluded, limited or made conditional his own liability or there is no contract to the contrary.
(d) Notice of dishonor has been given to or received by the endorser.

Liability of prior parties (Section 36) –

Prior parties (maker or drawer, acceptor and endorsers) to a negotiable instrument are jointly and severally liable to a holder in due course till the satisfaction of the instrument. Holder in due course has the option of making all or any of the prior parties liable. The liability of the parties *inter se* depends on the nature of liability of each.

Besides these provisions, Section 28 and 29 state the liability of agent and the legal representatives signing. Under Section 28, agent who signs his name to a promissory note, bill of exchange or cheque without indicating that he signs as agent or he does not intend to

incur personal responsibility is liable personally on the instrument. He is however liable to those who induced him to sign upon the belief that the principal only would be held liable. As per Section 29, legal representative of a deceased person who signs his name to a promissory note, bill of exchange is liable personally on it unless he expressly limits his liability to the extent of the assets received by him.

12.9 LAW AND PROCEDURE OF PRESENTMENT

Law provides that bills, cheques and notes have to be presented for payment to its acceptor, drawee or maker respectively by or on behalf of the holder of the instrument. Presentment is not necessary in case the maker, drawer or acceptor of the instruments obstructs presentment of the instrument either by his absence or any other willful act such as closure of business place on the date of presentment. Presentment is also not required if no one is present to make payment at the place specified for payment. Presentment can also be expressly or impliedly waived. Presentment is also not required if there is a promise to pay nothwithstanding non-presentment or the position of the drawer is such that he will not suffer any damage due to non-presentment. The legal personality of the drawer and the drawee also determines the possibility of presentment. If the drawer is fictitious or if the drawer and the drawee are one and the same person, presentment is not required. Further, circumstances making presentment impossible such as war, emergency etc. also make presentment non-essential. Except in the circumstances where the presentation is unnecessary, the presentations need to be made in accordance with the following norms of Negotiable Instruments Act.

(a) Bill of exchange payable after sight (no time or place is specified) must be presented to the drawee for acceptance by a person entitled to demand acceptance. The presentment should be made within reasonable time after it is drawn. The presentment should be in business hours on a business day. If the drawee cannot be found after reasonable search, the bill is dishonoured (Section 61).

(b) Bill directed to drawee at particular place must be presented at that place. If the drawee at the date of presentment cannot be found after reasonable search, bill is dishonoured (Section 61).

(c) Promissory note, payable after sight should be presented to the maker thereof for sight. The presentment should be by a person entitled to demand payment and must be made within reasonable time after being made. The said presentment should be in business hours on a business day. If there is default of presentment, no party is liable

to the person making such default (Section 62).

(d) If required by the drawee of a bill of exchange, the holder must allow the drawee forty eight hours to consider whether he will accept it or not (Section 63).

(e) Promissory notes, bill of exchange and cheques must be presented for payment to the maker, acceptor or drawee thereof respectively. The presentment must be by or on behalf of the holder. In case of default of presentment, other parties will not be liable to the holder. In case of promissory note payable on demand not at any specified place, presentment is not necessary to charge the maker thereof. In case electronic image of a truncated cheque is presented for payment, drawee bank is entitled to demand further information about the truncated cheque from the bank holding the truncated cheque if there is reasonable suspicion about the genuineness of the tenor of the instrument. If there is suspicion of any fraud, forgery, tampering or destruction of instrument, drawee bank can demand presentment of the truncated cheque itself for verification. On payment being made, the truncated cheque demanded by the drawee bank will be retained by it (Section 64).

(f) Presentment for payment has to be made during usual hours of business or within banking hours (Section 65).

(g) Promissory note or bill of exchange, made payable at specified period after date or sight thereof, must be presented for payment at maturity (Section 66).

(h) Promissory note payable by installments must be presented for payment on third day after date fixed for payment of each installment. Non-payment on presentment has the same effect as non-payment of a note at maturity (Section 67).

(i) Promissory note, bill of exchange or cheque made, drawn or accepted payable at specified place, must be presented for payment at that place to charge any party thereto (Section 68).

(j) Promissory note or bill of exchange, not payable at a specified place, has to be presented for payment at place of business or at usual residence of maker, drawee or acceptor thereof (Section 70).

(k) If maker, drawee or acceptor of negotiable instrument has no known place of business or fixed residence and also the instrument does not specify a place for presentment for acceptance or payment, presentment can be made to him in person wherever he can be found (Section 71).

(l) A cheque to charge the drawer should be presented at the bank upon which it is drawn before relation between drawer and his banker has been altered to prejudice of

drawer (Section 72).

(m) Cheque to charge any person except the drawer has to be presented within a reasonable time after delivery thereof by such person (Section 73).

(n) Negotiable instruments payable on demand must be presented for payment within a reasonable time after being received by the holder (Section 74).

(o) Presentment for acceptance or payment has to be made to duly authorized agent of drawee, maker or acceptor or if the drawee, maker or acceptor has died, to his legal representative or if he has been declared insolvent, to his assignee (Section 75).

(p) Delay in presentment is excused, if delay is caused by circumstances beyond control of holder. Such delay should not be imputable to his default, misconduct or negligence. If the cause of delay ceases to operate, presentment must be made within reasonable time (Section 75A).

Presentment for payment is not necessary and the instrument is dishonoured at due date for presentment in the following situations.

i. If maker, drawee or acceptor intentionally prevents presentment of instrument.
ii. If the instrument is payable at the place of business of maker, drawee or acceptor and such place of business is closed on a business day during usual business hours or if the instrument is payable at some other place and neither the maker, drawee or acceptor or any person authorized to pay it is present at the place during usual business hours.
iii. If the instrument is not payable at any specified place, the drawee, maker or acceptor cannot be found after due search.
iv. If payment is made notwithstanding non-presentment.
v. If after maturity and with knowledge that instrument has not been presented, any party makes part payment on the amount due on the instrument or promises to pay the amount due or waives right to take advantage of any default in presentment for payment.
vi. If the drawer does not suffer damage from want of such presentment. (Section 76)

If a bill of exchange, payable at a specified bank is presented for payment and dishonoured and the banker negligently or improperly keeps, deals with or delivers back such bill so as to cause loss to the holder, banker must compensate the holder for such loss. (Section 77)

12.10 HONOR AND DISHONOR OF NEGOTIABLE INSTRUMENTS

Dishonor of bill of exchange by non-acceptance (Section 91):

Bill of exchange can be dishonored by non-acceptance if the drawee or one of the several drawees who are not partners, make default in acceptance when it is required to accept the bill or in case where presentment is excused, bill is not accepted. In case the drawee is incompetent to contract or acceptance is qualified, bill can be treated as dishonored.

Dishonor of promissory note, bill of exchange or cheque by non-payment (Section 92):

Promissory note, bill of exchange or cheque would be dishonored by non-payment if the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment when required to pay the same. In case the instrument is dishonored by non-payment, the holder or party liable on it has to give notice of dishonor of instrument to all other parties whom the holder wants to make severally liable. The maker of dishonored promissory note or acceptor of dishonored bill of exchange or cheque need not be given notice (Section 93).

The said notice can be given to a duly authorized agent of the person to whom it is required to be given or on his death, notice can be given to his legal representative. In case such person has been declared to be insolvent, the notice can be given to his assignee. The notice can be either oral or written. If it is written, it has to be sent by post. No specific format has been prescribed for written notice. However, the contents of the notice should be such that it has the effect of informing the party to whom it is given that the instrument has been dishonored. Notice should state the manner in which such person is liable. The notice must be given within reasonable time after dishonor and should be given at the place of business of the person. In case such person has no place of business, notice can be given at the residence of such person (Section 94).

If a party receives a notice of dishonor of instrument and such party wants to make any prior party liable, such party should give notice of dishonor to such other party within reasonable time. No such notice is required to be given if such party receives due notice under section 93 of the Negotiable Instruments Act (Section 95).

In case the instrument is deposited with an agent for presentment, agent is entitled to the same time to give notice to his principal as if he was the holder giving notice of dishonor and the principal is entitled to a further like period to give notice of dishonor

(Section 96). In case notice is dispatched to a person who is dead but the person giving the notice is ignorant of the fact, such notice is deemed to be sufficient in law (Section 97).

Notice of dishonor is unnecessary in the following circumstances:

(a) If the party entitled to it dispenses with it;

(b) In case the payment has been countermanded by drawer, notice need not be given to charge the drawer;

(c) If the party charged does not suffer any damage for want of notice;

(d) If the party entitled to notice cannot be found after due search or the party bound to give notice is unable to do so without any fault of his;

(e) In case party wants to charge the drawer, no notice is required if the acceptor is also a drawer;

(f) In case of not negotiable promissory notes;

(g) In case where party entitled to notice, knows the facts and unconditionally promises to pay the amount due on the instrument (Section 98).

Reasonable time for giving notice:

Reasonable time for giving notice of dishonor will depend upon the nature of the instrument and the usual course of dealing with respect to similar instruments. For the purpose of calculating reasonable time, public holidays must be excluded (Section 105). If holder and party to whom notice of dishonor is given carry on business or live in different place, notice is given within reasonable time if it is dispatched by the next post or on the day next after the day of dishonor. If the parties carry on business or live in the same place, notice is given within a reasonable time if it is dispatched in time to reach its destination on the day next after the day of dishonor (Section 106). A party who receives notice of dishonor and wants to seek to enforce his right against a prior party is deemed to transmit the notice within a reasonable time, if he transmits it within the same time after its receipt as he would have had to give notice if he had been the holder. (Section 107)

Acceptance of bill of exchange for honor:

Bill of exchange which has been noted or protested for non-acceptance or for better security, can be accepted by any party other than the party already liable on it by writing on the bill for the honor of any party thereto (Section 108). Such person must by writing on the bill under his hand declare that he accepts under protest the protested bill for the honor of the drawer or a particular endorser or generally for honor (Section 109). If the acceptance does not express for whose honor it is made, it is presumed that it is made for the honor of the drawer (Section 110).

Drawee in case of need:

If drawee in case of need is named in a bill of exchange, bill is not dishonored until it is dishonored by such drawee (Section 115).

12.11 MATERIAL ALTERATIONS

Section 125 of the Negotiable instruments Act provides for material alteration. As the name suggests, material alterations are those which affect the validity and acceptance of the negotiable instrument. These are substantial changes which are ought not to be ignored by the banker. The following are regarded as material alteration:

(a) Change in date;
(b) Change in sum payable either for principal or interest;
(c) Change in time or place of payment;
(d) Change in the number or the relation of the parties;
(e) Change in medium or currency in which payment is to be made;
(f) Addition of a place of payment in case no place of payment is specified or
(g) Any change or addition which alters the effect of the instrument**.**

12.12 SUMMARY

Section 13 of the Negotiable Instruments Act provides that a negotiable instrument is a promissory note, bill of exchange or a cheque payable either to order or to bearer. Thus the statute recognizes three kinds of negotiable instruments. Section 4 of the Negotiable instruments Act defines 'Promissory note' as "an instrument in writing (not being a bank-note or a currency- note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument". Section 5 of the Negotiable Instruments Act defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument". Section 6 of the Act defines cheque as "A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand". The Act provides for the rights and duties of the parties to these instruments in detail. The mechanism of presentment and honour and dishonour of negotiable instruments are also detailed out under the Act.

12.13 KEY WORDS

1. Promissory Note
2. Bills of exchange

3. Hundi
4. Cheque
5. Traveller's cheque
6. Bank Draft
7. Dishonor
8. Material Alteration

12.14 SELF ASSESSMENT QUESTIONS

1. Define the following- Promissory Note, Bills of Exchange, Cheque, Hundis.

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2. What do you mean by presentment? Discuss the norms on presentment under the Negotiable Instruments Act.

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3. Under what circumstances dishonour of cheques is legally permissible?

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4. What are material alterations?

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5. What are the advantages and disadvantages of Travellers Cheque?

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12.15 REFERENCES

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UNIT-13: NEGOTIABLE INSTRUMENTS – LAW AND PROCEDURE

Structure:

13.0 Objectives

13.1 Introduction

13.2. Crossing of cheques

13.3. Criminal liability on dishonor of cheques

13.4. Noting and protesting

13.5. Law relating to payment of customer's cheques

13.6. Rights and duties of paying bankers and the collecting banker

- 13.6.1 Collecting Banker
- 13.6.2 Duties of Collecting Banker
- 13.6.3 Paying Banker
- 13.6.4 Duties of Paying Banker

13.7 Summary

13.8 Key words

13.9 Self Assessment Questions

13.10 References

13.0 OBJECTIVES

- To know the law relating to crossing of cheques and noting and protesting.
- To understand the law on payment of customer's cheque and criminal liabilities in case of cheque dishonour.
- To know the rights and duties of the Paying and the Collecting Banker.

13.1 INTRODUCTION

Cheques are very important negotiable instruments playing a very vital role in financial transactions. This Unit focuses exclusively upon various aspects of cheques such as crossing of cheques, payment upon it, liabilities in case of dishonor, noting and protest and rights and duties of paying and collecting bank with respect to it.

13.2 CROSSING OF CHEQUES

Chapter XIV of the Negotiable Instruments Act provides for crossing of cheques. Crossing of cheques can be –General or Special. The effect of crossing is that the paying bank is not supposed to pay the cheque across the counter but only to the banker. In case of cheques specially crossed, the payment has to be made to the specified banker and it is more secure than cheques generally crossed. Crossing is preferred as it is easy to trace the person to whom the payment is made. Also, post payment, the drawer is placed in the same position as if the cheque was paid to the true owner. This is because payment of a crossed cheque amounts to 'payment in due course'. This benefit is also available to the banker under Section 128. The banker gets a right to debit the account of the customer irrespective of whether the amount has been paid or not to the true owner.

Section 123 provides for 'cheque crossed generally'. Cheques bearing across its face, an addition of the words 'and company' or any abbreviation, between two parallel transverse lines are deemed to be crossed and the addition is deemed a crossing. The words 'not negotiable' may or may not be mentioned.

Section 126 provides for the payment mechanism of cheques crossed generally. It provides that in case a cheque is crossed generally, banker on whom it is drawn shall not pay it otherwise than to a banker.

Section 124 provides for cheques crossed specially. Cheques are deemed to be crossed specially when a cheque bears across its face an addition of the name of the banker. The words "not negotiable" may or may not be there. The addition is deemed a crossing and the cheque is deemed to be crossed specially and is deemed to be crossed to the banker.

Section 126 provides that where a cheque is crossed specially, banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed. Payment can be made to the agent of the banker. Section 127 provides for payment of cheques crossed specially more than once. It provides that in case a cheque is crossed specially to more than one banker (except when crossed to an agent for collection), banker on whom it is drawn shall refuse payment thereof.

In case a cheque crossed generally or specially has the words "not negotiable" written across it, such a cheque is not capable of giving a better title to the cheque than that which the person from whom he took.

Cheques can be crossed after issue. Section 125 lists down the various circumstances under which cheques can be crossed by the holder or banker. These are:

(a) If a cheque is uncrossed, holder can cross it generally or specially.

(b) If a cheque is crossed generally, holder can cross it specially.

(c) If a cheque is crossed generally or specially, holder can add the words "not negotiable".

(d) If a cheque is crossed specially, banker to whom it is crossed can again cross it specially to another banker (his agent) for collection.

A banker is not liable to the owner of the cheque for receiving any payment, if the title to the cheque is proved defective subsequently. Section 131 provides that if a banker in good faith and without negligence receives payment for a customer of a cheque crossed generally or specially, the banker shall not incur any liability to the true owner of the cheque for receiving such payment, if the title to the cheque is proved defective subsequently.

In *Indian Overseas Bank* v. *Industrial Chain Concern* [JR 989 (4) SC 334], Court held that for a bank to have the immunity under Section 131 as the collecting banker, the conditions specified under the section need to be fulfilled. The onus of having met the conditions specified under the section is upon the banker. This includes that a) banker should have acted in good faith and without negligence in receiving the payment; b) banker should act as a mere agent and should collect the cheque on behalf of the customer; c) the person for whom the banker acts must be the customer of the bank and d) cheque must be crossed generally or specially to himself.

13.3 CRIMINAL LIABILITY ON DISHONOR OF CHEQUES

Chapter XVII of the Negotiable Instruments Act 1881 provides for penalties in case of dishonour of certain cheques for insufficiency of funds in the account. Section 138 of the said

Act provides that dishonour of cheques due to insufficiency of funds is a criminal offence and is punishable with imprisonment for a term which may extend to two year or with fine which may extend to twice the amount of the cheque or with both. The conditions essential for the application of Section 138 are:

(a) Cheque should be drawn by a person on an account maintained by him with a banker.

(b) The cheque should be for payment of any amount of money to another person from out of that account for discharge of any debt or other liability. Explanation to the Section clarifies that such debt or liability should be legally enforceable. Further, under Section 139, a rebuttable presumption is drawn in favour of holder of cheque. It is provided that it shall be presumed that the holder of a cheque received the cheque for the discharge of any debt or liability.

(c) The said cheque should be returned by the bank unpaid as amount of money standing to the credit of that account is insufficient to honour the cheque or amount exceeds the amount arranged to be paid from that account by an agreement made with that bank.

In *K.P.G. Nair* v. *Jindal Menthol India Ltd.* [JT 2000 (Suppl) SC 519], Criminal proceedings were initiated against the Director of the accused company for offences punishable under Negotiable Instruments Act 1881. Deciding upon a petition for quashing of the criminal proceedings, the Court held that it was evident from the facts that the Director of the accused company was in charge of and responsible for the business of the accused company. Court held that under Section 141 and 138 of the Negotiable instruments Act 1881, every person who is in charge of and responsible for business of company at the time of offence can be prosecuted. Director in the present case was one such person.

For invoking Section 138, the following additional requirements must be fulfilled:

(a) The cheque should be presented to the bank within a period of six months from the date on which it is drawn or within the period of its validity, whichever is earlier;

(b) The payee (or holder in due course) should make a demand for payment of the said amount of money by giving a notice in writing to the drawer of the cheque. Such notice should be given within 15 days of receipt of information of the return of cheque as unpaid;

(c) Drawer of the cheque should fail to make the payment of the amount of money to the payee (or holder in due course), within 15 days of receipt of said notice.

In *Cranex Ltd.* v. *Nagarjuna Finance Ltd.* [JT 2000 (Suppl 1) SC 82], Appellant was convicted in a criminal appeal arising out of proceedings under section 138 of the Negotiable

Instruments Act 1881. While the appeal against conviction and sentence was pending, payment of money was done under settlement. Under these circumstances, Court held that court will have to consider whether the conviction is to be maintained or an order of imposition of fine is to be passed. Subsequent changes were to be taken into record and the case was sent back for fresh disposal. To make Section 138 more rigorous, Section 140 provides that drawer cannot take the defence that he had no reason to believe at the time of issuing the cheque that the cheque may be dishonoured on presentment. Offence under Section 138 assumes more serious proportions if it is committed by companies. Section 141 lays down the law in this regard. It provides that in case the offence under Section 138 is committed by a company (a body corporate and includes a firm or other association of individuals), then the company shall be punished accordingly. Persons liable to be prosecuted under the section include every person who at the time of commission of the offence was in charge of and was responsible to the company for the conduct of the business of the company and the company itself. A person can claim exemption from liability if he is able to prove that the offence was committed without his knowledge or he had exercised all due diligence to prevent commission of offence. In case the offence is committed with the consent or connivance or neglect of any officer including the director (in relation to a firm, 'director' includes a partner in the firm), manager, secretary, of the company, such officer shall be deemed to be guilty of the offence.

Prior to taking cognizance of an offence under Section 138, the following conditions must be fulfilled:

(a) A complaint in writing should be made by the payee or the holder in due course of the cheque;

(b) Complaint should be made within one month of the date on which the cause of action arises;

(c) Cognizance cannot be taken by a court inferior to that of a Metropolitan Magistrate or Judicial Magistrate of the first class. As per section 143, Metropolitan Magistrate or Judicial Magistrate of first class can try the cases summarily and in case of summary trial, maximum imprisonment will be one year and minimum fine will be ₹5,000/-.

Complaint for dishonour of cheques can be filed at one of the following jurisdictions.

(a) Place where cheques was drawn.

(b) Place where cheque was presented.

(c) Place where cheque was returned unpaid by the bank.

(d) Place where notice was issued to drawer.

(e) Place where drawer failed to pay the amount in response to notice.

The complaint under section 138 should contain the following facts/details:

(a) Name of complainant and the accused.

(b) Summary of the circumstances giving rise to the 'debt or liability'.

(c) Cheque number, date, bank name and amount for which cheque was drawn by drawer.

(d) Date of intimation of dishonour of cheque received by complainant and date of legal notice sent by complainant.

(e) Fact of failure of drawer to make payment within 15 days.

(f) Prayer to initiate legal action against accused.

(g) List of witnesses.

(h) Documentary proof as annexure.

In *K. Bhaskaran* v. *Sankaran Vaidhyan Balan* [(2000) 99 Comp Cas 268] deciding upon the jurisdiction of the court to try cases arising under Negotiable Instruments Act 1881, the court held that the place where the bank which dishonoured the cheque is situated cannot be regarded as the sole criteria for determining the place of offence. Offence is not complete with the dishonour of the cheque. It is complete when the drawer of the cheque fails to pay the amount due under the cheque within fourteen days as per clause (c) of the proviso to Section 136. For the purpose of jurisdiction, place where the drawer is residing, place where the payee is residing or the place where either the drawer or the payee carry on business are relevant. In case offence is committed partly in one area and partly in another area, court of either of the places can have jurisdiction to try the case.

The court further held that there are five components of an offence under section 138 of the Negotiable instruments Act 1881. These are namely, drawing of the cheque, presentation of the cheque to the bank, returning of the cheque unpaid by the bank, giving notice in writing to the drawer of the cheque demanding payment of amount covered under the cheque and failure of the drawer to make the payment within the stipulated period. The five components can take place in five different jurisdictions and all the five courts will have jurisdiction to try the matter.

Section 143 further provides that as far as practicable, trial should be continued from day to day until its conclusion and endeavour should be made to conclude the trial within six months from the date of filing of complaint. As per Section 146, the Court shall on production of bank's slip or memo having thereon the official mark denoting that the cheque

has been dishonoured, presume the fact of dishonour of such cheque, unless and until such fact is disproved. Section 147 provides that the offence is compoundable. Master Circular on Customer Service in Banks issued by Reserve Bank provides for the procedure to be followed in case of dishonour of cheques. Few key provisions are discussed herein below:

Banks are required to implement the recommendation of the Goiporia Committee that dishonoured instruments are returned / despatched to the customer promptly without delay, in any case within 24 hours.

The paying bank should return dishonoured cheques presented through clearing houses strictly as per the return discipline prescribed for respective clearing house in terms of Uniform Regulations and Rules for Bankers' Clearing Houses. The collecting bank on receipt of such dishonoured cheques should despatch it immediately to the payees / holders. In relation to cheques presented direct to the paying bank for settlement of transaction by way of transfer between two accounts with that bank, it should return such dishonoured cheques to payees/ holders immediately. In case of dishonor / return of cheques, the paying banks should clearly indicate the return reason code on the return memo / objection slip which should also bear the signature / initial of the bank officials as prescribed in Rule 6 of the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH). Data in respect of each dishonoured cheque for the amount of ₹ 1 crore and above should be made part of bank's MIS on constituents and concerned branches should report such data to their respective controlling office / Head Office.

Data in respect of cheques drawn in favour of stock exchanges and dishonoured should be consolidated separately by banks irrespective of the value of such cheques as a part of their MIS relating to broker entities, and be reported to their respective Head Offices / Central Offices. To deal with incidents of frequent dishonour of cheques of value Rs. 1 crore and above banks should introduce a condition for operation of accounts with cheque facility that in the event of dishonour of a cheque valuing rupees one crore and above drawn on a particular account of the drawer on four occasions during the financial year for want of sufficient funds in the account, no fresh cheque book would be issued. Banks can also consider closing current account at its discretion.

If a cheque is dishonoured for a third time on a particular account of the drawer during the financial year, banks should issue a cautionary advice to the concerned constituent. Similar cautionary advice may be issued if a bank intends to close the account. To deal with frequent dishonour of cheques of value of less than ₹ 1 crore banks are advised to have a Board approved policy. In any proceeding relating to dishonoured cheque before a court,

consumer forum or any other competent authority, banks should extend full co-operation, and should furnish documentary proof of fact of dishonour of cheques to the complainant. Banks are advised to adopt, with the approval of their respective Boards, appropriate procedure for dealing with dishonoured cheques with inherent preventive measures and checks to prevent any scope for collusion of the staff of the bank or any other person, with the drawer of the cheque for causing delay in or withholding the communication of the fact of dishonour of the cheque to the payee/ holder or the return of such dishonoured cheque to him.

Banks should also lay down requisite internal guidelines for their officers and staff and advise them to adhere to such guidelines and ensure strict compliance thereof to achieve effective communication and delivery of dishonoured cheque to the payee.

13.4 NOTING AND PROTESTING

Chapter IX of Negotiable instruments Act 1881 provides for noting and protesting.

Noting:

Section 99 describes the process of noting. Noting is primarily a method by which fact of dishonour of a note or bill is authenticated. It is a minute recorded by a notary public. Section 99 provides that in case a promissory note or bill of exchange is dishonoured, either due to non-acceptance or non-payment, the holder can cause the dishonour to be noted by a notary public. Noting can either be upon the instrument itself or upon a paper attached to it or partly upon each. When an instrument is presented to the notary for noting, Notary Public has to present it to the drawee or acceptor for acceptance or payment. Only if the drawee or acceptor refuses to accept or make payment, can the Notary public proceed with noting. The note should be made within a reasonable time after dishonour and should specify:

(a) Date of dishonour
(b) Reasons if any for dishonour
(c) If the instrument has not been expressly dishonoured, reason why the holder treats it as dishonoured.
(d) Notary's charges.

Protesting:

The holder has a further recourse in the form of protesting. Section 100 provides for protesting. In case of protesting, the Notary Public certifies that the bill or note has been dishonoured and the said certificate is called a protest. The essentials of protest under Section 100 are; (i) The promissory note or bill of exchange has been dishonoured by non-acceptance or non-payment, and (ii) Holder causes such dishonour to be noted and certified by a notary

public within a reasonable time. Such certificate is called a protest. Noting and protesting provide evidence of the fact of dishonour of instrument in a court of law. While court may or may not recognize noting, it is bound to recognize protesting. Protesting is resorted to more with the intention of prosecuting the defaulter before a court of law.

Protest for better security:

Protest can also be for better security. Such certificates are issued in case –

(a) Acceptor of a bill of exchange becomes insolvent or his credit is publicly impeached before maturity of bill.
(b) Holder within reasonable time causes a Notary Public to demand better security of the acceptor.
(c) The acceptor refuses the request of Notary Public to furnish better security.
(d) The Notary public on refusal, within reasonable time causes such facts to be noted and certified.

Contents of protest:

Section 101 provides for the contents of protest. Protest under Section 100 must contain the following information:

(a) The instrument itself or a literal transcript of the instrument and everything written or printed thereupon;
(b) Name of the person for whom and against whom the instrument has been protested;
(c) A statement that payment or acceptance, or better security (as the case may be) has been demanded of such person by the notary public. Demand can be made either by the Notary Public in person or by his clerk if it is so authorized by agreement or usage. The demand has to be made by registered letter.
(d) Statement of terms of his answer (if any) or a statement that he gave no answer or that he could not be found;
(e) Place and time of dishonour in case of dishonour of note or bill;
(f) Place and time of refusal of better security in case of refusal of better security;
(g) Subscription of the notary public making the protest;
(h) In case of an acceptance for honour or of a payment for honour, name of the person by whom, of the person for whom, and the manner in which, such acceptance or payment was offered and effected.

In case a promissory note or bill of exchange has to be protested by law, notice of such protest should be given instead of notice of dishonour. The notice has to be given in the same manner and subject to the same conditions as a notice of dishonour. However, such

notice may be given by the notary public who makes the protest (Section 102). Also, bills of exchange which are drawn payable at any place other than the place mentioned as the residence of the drawee shall in case of being dishonoured by non-acceptance be protested for non-payment in the place specified for payment. There is no further requirement of presentation to the drawee (Section 103). While noting or protesting is not compulsory in case of inland bill, foreign bills of exchange have to be compulsorily protested under Section 104 in case of dishonour if such protest is required by the law of the place where they are drawn. Given the importance of protesting as evidence of dishonour of an instrument in a court of law, Section 104A provides that in case a bill or note has to be protested within a specified time or before some proceedings is taken, in such cases, it is sufficient if the bill has been noted for protest before expiration of the specified time or taking of the proceeding and the formal protest is extended at any time thereafter as of the date of noting.

13.5 LAW RELATING TO PAYMENT OF CUSTOMER'S CHEQUES

A banker is under an obligation to honour his customer's cheque. If the banker dishonours the cheque in spite of sufficient funds of the customer, banker is liable to pay damages. The Reserve Bank has come up with a number of regulations pertaining to cheque payment. While a number of areas are regulated, in some spheres banks have been left free to decide their policy. Few of the key regulations pertaining to payment of customer's cheques are broadly discussed hereunder: Reserve Bank has prescribed certain benchmark for standardization of cheques issued. These standards are known as "CTS- 2010 standard". These include provision of mandatory minimum security features on cheque forms like quality of paper, watermark, bank's logo in invisible ink, void pantograph, etc. and standardization of field placements on cheques.

With effect from 1 February 2011, Speed Clearing System has been extended to cover all transaction codes. Previously, it included cheques issued by account holders with transaction codes 10 (savings bank), 11 (current account) and 13 (cash credit). Also, it has now been extended to Non- MICR centres. Reserve Bank has decided to extend the coverage to Non-MICR centres in a phased manner since January 2011. Speed Clearing System is applicable for collection of outstation cheques in local clearing treating the instruments as locally drawn.

No changes are allowed to be carried out on cheques. For any changes in payee's name, courtesy amount (amount in figures) or legal amount (amount in words) etc, excepting change in date for validation period, fresh cheque forms should be used by customers. In

case of Dishonour /Return of cheque, 'Date of Return' should be mentioned in the Cheque Return Memo. Rule 6 of the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH) provides that the objection slip is to be signed/initialled giving a definite and valid reason for refusing payment. Period of validity of cheques has been reduced from six months to three month from 1 April 2012.

Banks are prohibited from crediting 'account payee' cheques to the account of any person other than the payee named therein. An exception to the rule is that banks are allowed to collect account payee cheques drawn for an amount not exceeding Rs.50,000/- to the account of the customers of co-operative credit societies. Compensation to customers for delay in collection of outstation cheques should be paid without any request from the customer. Banks have to collect outstation cheques in 14 days and in case of delay, have to pay interest at specified rate or equivalent to fixed deposit rate for corresponding maturity. Service charge has been made system enabled. This means, the recovery of service charge happens automatically. Service charges for savings bank customer for collection of outstation cheques up to Rs.1.00 lakh has been mandated by Reserve Bank with effect from 1 April 2011. Banks are free to fix charges for current account customers and for collection of outstation cheques beyond Rs.1.00 lakh.

For collection of outstation cheques at centres where Speed Clearing System is not present, collecting and paying banker has to share 50:50 charges for collection of outstation cheques. Banks should have drop box facility and facility for acknowledgement of cheques at regular collection counters for customers. No branch should refuse to give an acknowledgement if customer tenders the cheque at the counters. Banks should ensure that customers are not compelled to drop the cheques in the drop-box. Banks should make customer aware of both the options available to him, that is, dropping cheques in the drop-box or tendering them at the counters. Banks should display on the cheque drop-box that 'Customers can also tender the cheques at the counter and obtain acknowledgment on the pay-in-slips'. This message should be displayed in English, Hindi and the concerned regional language of the State.

Cheques issued by clients containing fractions of a rupee should not be rejected or dishonoured.

Banks have to pay compensation at savings bank interest rate, for delayed clearance of local cheques, in case there is no specified rate. Banks have to reframe their Cheque Collection Policies (CCP) and specify details regarding timeline for clearance of local cheques, compensation for delay etc. these information have to be displayed on bank

websites. Reserve Bank has started the Cheque Truncation System whereby images of cheques are scanned and electronically sent to the concerned branches, for inward and outward clearing. The paying branch receives images for inward clearing and pays and sends facsimile of cheque back to the clearing centre and vice versa. This system is presently implemented on pilot basis at New Delhi and Chennai. Banks can levy charges at a rate not exceeding ₹ 150/- plus service tax as applicable per instruments for clearing high value instruments (i.e. for cheques of value above Rs.1 lakh presented in Speed Clearing). Banks are prohibited from levying any additional charges for clearing cheques up to and including Rs.1 lakh in Speed Clearing. Reserve Bank is taking efforts to extend Core Banking Solution to all banks. As regards cheque collection, this would lead to same day credit in case of local cheques and reduced time frame for inter-city cheques. Reserve Bank has introduced 66 MICR-Clearing Centres for collection of Inward and Outward Clearing of MICR cheques/instruments. MICR instruments received in Drop-Boxes or across the counter are segregated and sent to Service Branch for onward presentation to MICR Clearing Centre for fast clearing.

13.6 RIGHTS AND DUTIES OF PAYING BANKERS AND THE COLLECTING BANKER

13.6.1 Collecting Banker

Collecting banker is a banker who undertakes to collect various types of instruments in favour of his customer or on his own behalf from drawers of such instrument. The instruments can be negotiable or quasi negotiable.

13.6.2 Duties of Collecting Banker

Banker acts as the agent of the customer while collecting an instrument. As agent of the customer, banker has to take such steps as are necessary to protect the interests of the customer. The test applicable here is that the steps should be such as will be taken by a man of ordinary prudence to protect his own interest. In case the cheque is drawn at a place where the collecting bank is not a member of the clearing house, the collecting bank can designate another bank for collecting the cheque. Such other bank should be a member of the clearing house.

As part of his duty, collecting bank has to present the instrument to the paying bank in due time and to collect and credit the proceeds of the instrument in the payee's account. In this regard, Section 84 of the Negotiable Instruments Act 1881 provides that "Where a cheque is not presented for payment within a reasonable time of its issue, and the drawer or

person in whose account it is drawn had the right, at the time when presentment ought to have been made, as between himself and the banker, to have the cheque paid and suffers actual damage, through the delay, he is discharged to the extent of such damage, that is to say, to the extent to which such drawer or person is a creditor of the banker to a large amount than he would have been if such cheque had been paid."

Further, in case of dishonour of instrument, it is the duty of the collecting bank to inform the customer of the same. If the collecting bank fails to give such notice and the customer suffers any loss on account of it, the collecting bank is liable to the customer for such loss. The obligation of giving notice to customer also exists in case the cheque is returned by drawee bank for confirmation of endorsement. Even in such cases on return of cheque, collecting bank is liable to the customer for loss suffered.

The collecting bank while acting as the agent is provided protection under Section 131 of the Negotiable Instruments Act 1881. The section provides that the collecting bank is not responsible to the owner of a cheque/bank draft in case of defective title to the instrument. The cheque or draft must be crossed (generally or specially) to the bank and should have been collected in good faith and without negligence. The protection available to the bank is a limited one and does not extend to cover acts of negligence on part of the bank. Thus, no protection is available in case the proceeds of the cheque are credited to an endorsee without proper endorsement or proceeds of a cheque are credited to a wrong account. For example, in case of a cheque payable to a company, the proceeds being credited to the account of any of its officers such as director, managing partner etc.

Banker is responsible for checking that the instruments collected are proper. These include careful scrutiny of instruments for checking name of holder, date of instrument, amount, signature, alterations whether material, endorsement etc. Collecting banker has no obligation to collect bills of exchange for its customers. Such an obligation can however be voluntarily undertaken by the banker for a fee. In such cases, where such facility is provided to the customer, the banker is under an obligation to exercise due diligence in verifying the title of his customer towards the bill of exchange.

13.6.3 Paying Banker

A banker on whom the instrument is drawn and who is bound to make payment upon its presentation is known as the paying banker.

13.6.4 Duties of Paying Bank

As per Section 31 of the Negotiable Instruments Act 1881, banker is under an obligation to honour the customer's instrument subject to the availability of funds and

absence of any legal bar for payment. In *Delhi Cloth and General Mills Co. Ltd.* v. *Harnam Singh* [AIR 1955 SC 590], deciding upon the obligation of the bank to pay, court held that bank's obligation to pay cheques of the customers depends upon the branch at which customer keeps his account. Bank has the right to refuse to encash a cheque of any other branch. Customer has to make the demand for payment at the branch where the customer has his current account. Customer has his cause of action only against that bank. Court held that 'situs' of the debt is at the place where the current account is kept and this is where the demand must be made.

At the time of making payment, banker is supposed to exercise due diligence and properly verify the authenticity of the instrument. This includes looking into the signature of drawer, status of account (whether dormant, subject to liquidation process etc.), holder's title to the cheque, endorsement, sufficiency of funds in account, date of issue of instrument, any material alteration, crossing of cheque etc.

13.7 SUMMARY

Chapter XIV of the Negotiable Instruments Act provides for crossing of cheques. Crossing of cheques can be –General or Special. The effect of crossing is that the paying bank is not supposed to pay the cheque across the counter but only to the banker. A banker who undertakes to collect various types of instruments in favour of his customer or on his own behalf from drawers of such instrument is known as the collecting banker. A banker on whom the instrument is drawn and who is bound to make payment upon its presentation is known as the paying banker. A banker is under an obligation to honour his customer's cheque. If the banker dishonours the cheque in spite of sufficient funds of the customer, banker is liable to pay damages.

Chapter XVII of the Negotiable Instruments Act 1881 provides for penalties in case of dishonour of certain cheques for insufficiency of funds in account. Noting and protesting are two methods by which fact of dishonour of cheque is authenticated. In case of protesting, the Notary Public certifies that the bill or note has been dishonoured and the said certificate is called a protest.

13.8 KEY WORDS

1. Crossing of cheques
2. Noting
3. Protesting
4. Paying Banker

5. Collecting Banker
6. Customer's Cheque
7. Dishonour of Cheque
8. Notary public
9. Drawer
10. Drawee

13.9 SELF ASSESSMENT QUESTIONS

1. What do you mean by crossing of cheques? What are its advantages?

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2. Define Noting and Protesting.

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3. What are the criminal liabilities for dishonour of cheques?

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4. Mention the rights and duties of the Paying and the Collecting Banker.

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13.10 REFERENCES

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UNIT-14: NEGOTIABLE INSTRUMENTS -LAW AND PROCEDURE

Structure:

14.0 Objectives

14.1 Introduction

14.2. Honoring of customer's cheques

14.3. Overdraft agreements

14.4. Consequences of wrongful dishonor

14.5. When dishonor permissible?

14.6. Stale cheques

14.7. Statutory protection of the banker

14.8. Payments in due course

14.9. Fraud and forgery of customer's cheques

14.10. Holder and holder in due course

14.11 Cheques for third parties

4.12 Negotiation

14.13 Rules of evidence

14.14 Payment and interest

14.15 Summary

14.16 Key words

14.17 Self Assessment Questions

14.18 References

14.0 OBJECTIVES

- To understand the concept of honor and dishonour of cheques and consequences flowing from wrongful dishonour of cheques.
- To grasping essential concepts such as holder, holder in due course, negotiation, stale cheques, over draft facility etc.
- To have a thorough knowledge on different aspects relating to cheques.

14.1 INTRODUCTION

This Unit continues with the discussion in the previous Unit and harps upon a number of important concepts vital to the study of law on negotiable instruments. As previously mentioned, cheques are very vital negotiable instruments carrying upon them an obligation of the banker to honor them. In case the banker fails to fulfil this duty of his, a number of legal consequences follow. However, in certain cases the banker is allowed to dishonour cheques. The Unit also elaborates upon the legal concept of 'holder' and 'holder in due course' with special reference to the advantages available to the 'holder in due course'. Forgery of cheques is a menace and the existing law relating to it is discussed. Certain statutory protections available to the banker are also elaborated upon.

14.2 HONORING OF CUSTOMER'S CHEQUES

A banker is bound to honour the customer's cheque subject to certain conditions. When a banker opens the account of a customer, he impliedly undertakes the obligation of honoring the customer's cheque. In case the banker fails to honour the customer's cheque without any valid reason, the banker is liable to compensate the drawer. This liability extends only to the drawer of the cheque and not to any-one else. For a cheque to be honoured, the customer must have sufficient funds in his account. Also, the cheque must be presented during the regular banking hours. Besides, honoring the customer's cheque, a banker is required to keep a correct and up to date record of the account credits and debits.

14.3 OVERDRAFT AGREEMENTS

Overdraft facilities are provided by banks for a fee. Under this facility, the customer can withdraw money from his account, despite having zero balance. It is a credit facility provided by the bank and is usually subject to a limit which is fixed depending upon different factors such as the financial health of the customer, credit history of the customer, customer's assets and so on. Overdraft facility is very helpful for those who need to withdraw cash or cover business transactions on a day to day or regular basis. For other regular customers, who

don't necessarily require overdraft facilities for commercial purposes, overdraft facility provides a security against dishonour of cheques due to insufficient funds. Overdraft agreements providing for overdraft lay down the terms and conditions of such arrangement. An interest is charged as per the terms of the agreement over the money made available as credit. Overdraft agreements against property are very common as banks readily accept property as security for providing overdraft facilities. While negotiating an overdraft agreement with bank, a customer should keep two things in mind. Firstly, the overdraft limit and secondly the interest rate that is the rate at which bank computes and applies interest on the limit.

14.4 CONSEQUENCES OF WRONGFUL DISHONOR

A bank is bound to honour a valid negotiable instrument. In case a bank fails to fulfil this duty, subject to satisfaction of other conditions, bank will be liable for wrongful dishonour of the instrument. Wrongful dishonour of negotiable instruments due to negligence or mistake amounts to deficiency in services and the banker is liable to compensate for the same.

14.5 WHEN DISHONOR PERMISSIBLE

While the banker is liable for wrongful dishonor of a negotiable instrument, in certain cases banker can refuse payment and in such cases the refusal to honour the negotiable instrument is not wrongful. There might be cases wherein after issue of a cheque due to some subsequent developments, the customer instructs the banker not to make payment upon the cheque previously honoured. In such cases, due to the express instructions of the customer, the banker is obliged to refuse payment upon the cheque. In case the banker does not comply with the instructions, banker will be liable to compensate the customer for deficiency in services. For negotiable instruments of customer to be honoured, the customer must be legally capable of issuing valid negotiable instruments. Thus, where a banker receives a negotiable instrument after he receives notice of customer's death, insanity or assignment of credit balance of account or in cases where the customer has been adjudged an insolvent or where a Garnishee order has been passed, banker is obliged to refuse payment. Banker also has no obligation to honour negotiable instruments of the customer after the relation between the banker and the customer has come to an end. Thus cheques issued after account closure need not be honoured by the bank. In certain cases, banks have discretion to accept or refuse payment. These include cases where there are some technicalities such as minor alteration on the face of the instrument, instruments of doubtful integrity, instruments presented beyond

banking hours etc.

14.6 STALE CHEQUES

Cheques have a validity period. Cheques presented to payee post the said validity period are said to be stale. The validity period is decided by the financial body and is usually between 3 months to 12 months. Previously, the validity of cheques/ drafts/ pay orders/ bankers cheque was six months from the date of issue and validity of interest warrants/ dividend warrants and income tax refund orders (these are also treated as cheques) was three months from date of issue. Reserve Bank has changed the validity period of cheques/ drafts/ pay orders/ bankers cheque to three months from 1 April 2012. This has been done to prevent the practice of circulating the instruments in market like cash for six months.

14.7 STATUTORY PROTECTION OF THE BANKER

Section 10, 85 and 128 provide for the statutory protection of the banker. Section 10 and 128 provide for protection of the banker for payment made in due course and are discussed subsequently. Section 85 protects banker for payment made upon cheques in due course. Section 85 lays down that in cases where a cheque is payable to order and it purports to be endorsed by or on behalf of the payee, banker is discharged by payment in due course. Banker is not liable for subsequent discovery of endorsement being forged or endorsement being made by one who had no authority. In such cases, banker is not liable for debiting the account of the customer. The banker is not protected in case banker makes payment upon a cheque which becomes bearer by subsequent endorsement in blank. But the banker incurs no liability if he makes payment upon a bearer cheque which has any endorsement upon it and is paid to the bearer.

In *Bank of Bihar* v. *Mahabir Lal* [(1963) 33 Comp Cas 783], Plaintiff bank entered into an agreement with Defendant to give cash credit facilities. Defendant required credit for making some purchases. The said amount was advanced by the bank on the express condition that the same would be paid directly to the wholesaler and not to the Defendant. Money was given by the bank to its servant who was to be present at the place where it had to be paid to the wholesaler by the Defendant. Servant absconded with the money. Plaintiff bank sued the Defendant for recovery of money. Court held that as the money had been misappropriated by the Bank's employee, no liability on part of the Defendant arose to make good the loss. Further, Section 85 of the Negotiable Instruments Act was not applicable as no payment was made to the Defendant. Also, the principle of vicarious liability was inapplicable as a stranger could not be made liable for acts of servant of another.

14.8 PAYMENTS IN DUE COURSE

Payment in due course means a payment made under a negotiable instrument within its validity period/ upon maturity/ according to the intention of the parties; in good faith and without negligence. For a payment to be made in due course three conditions must be fulfilled. First, the payment has to be made within the tenor of the instrument, in good faith and without negligence. Second, the payment has to be made to the person reasonably believed to be entitled to receive the amount of which payment is made. This is generally the person in possession of the instrument. Third, the Payment should be made in money only.

Section 10 of the Negotiable Instruments Act 1881 lays down the law regarding payments made in due course. It provides that any person liable to make payment under a negotiable instrument has to make the payment in due course to obtain a valid discharge against the holder. A banker making payment in due course is protected under Section 10 and 128 of the Negotiable Instruments Act 1881.

14.9 FRAUD AND FORGERY OF CUSTOMER'S CHEQUES

Forgery of customer's cheque can take different forms such as:

(a) Use of original stolen cheques of customer.

(b) Alteration in the cheque written by a customer.

(c) Payment on fake cheques drawn on a non-existent account.

Banks are liable if forged cheques having clear signs of forgery are cleared by them. While banks are not required to get opinion of hand writing experts, in cases where forgery is clearly visible, banks are liable to pay compensation on the ground of negligence. In *Bhita Co-operative Development Cane Marketing Union Ltd.* v. *Bank of Bihar* [AIR 1967 SC 389], dispute arose between a registered society and a non-member. Signature on the customer's cheque was forged. Court held that as the signature on the cheque was forged issue of mandate by the customer to the banker did not arise. Also, there was negligence on part of the banker in not ascertaining the genuineness of the signature on the cheque. Facts of the case showed that the employees of the bank did not act bona fide and there was no negligence on part of the customer as the cheque had to be signed jointly directly by two persons, a condition which was not fulfilled in the present case. Court quoted the Halsbury Laws of England (3rd Edition) Vol. 2 Article 380 wherein it is provided "A document in cheque form to which the customer's name as drawer is forged or placed thereon without authority is not a cheque, but a mere nullity. Unless the banker can establish adoption or estoppels, he cannot debit the customer with any payment made on such document."

The Reserve Bank's 2013 Master Circular on Frauds- Classification and Reporting under paragraph 2 classifies frauds into following categories.

(a) Misappropriation and criminal breach of trust.

(b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(c) Unauthorised credit facilities extended for reward or for illegal gratification.

(d) Negligence and cash shortages.

(e) Cheating and forgery.

(f) Irregularities in foreign exchange transactions.

(g) Any other type of fraud not coming under the specific heads as above.

The Master Circular also provides certain key guidelines relating to fraud. First, frauds involving forged instruments are to be reported only by the paying bank and not by the collecting bank. In case of collection of instrument if the amount is credited and withdrawn before discovery of forgery, collecting bank has to report the same with Reserve Bank. Second, in case of encashment of altered/fake cheque involving two or more branches of the same bank, the fraud should be reported to the Head Office of the bank which is required to report the fraud with Reserve Bank. Third, in case of encashment of altered/fake cheque having been paid/encashed involving two or more branches of a bank under Core Banking Solution (CBS), branch which releases the payment against such cheque should report the fraud to Head Office which is to file a fraud report with Reserve Bank. Fourth, the Master Circular also provides guidelines to be followed by banks for reporting of frauds (including forgery) to Police.

According to the Master Circular, in dealing with cases of fraud/embezzlement, banks should not merely be motivated by the necessity of recovering expeditiously the amount involved, but should also be motivated by public interest and the need for ensuring that the guilty persons do not go unpunished. As a general rule, the following cases should invariably be referred to the State Police:

(a) Cases of fraud involving an amount of Rs. One lakh and above, committed by outsiders on their own and/or with the connivance of bank staff/officers.

(b) Cases of fraud committed by bank employees, when it involves banks' funds exceeding ₹10,000/-.

(c) In case of frauds involving forged instruments, the paying banker has to file the police complaint (FIR) and not the collecting banker.

(d) In case of collection of genuine instrument in which amount is fraudulently collected by a person who is not the owner, collecting bank which is defrauded has to file a police complaint.

(e) In case of collection of instruments where amount is credited before realisation and subsequently instrument is found to be fake/forged and returned by paying bank, collecting bank has to file a police complaint.

(f) In cases of collection of altered/fake cheque involving two or more branches of the same bank, branch where the altered/fake instrument has been encashed, should file a Police complaint.

(g) In case an altered / fake cheque has been paid /encashed and involves two or more branches of a bank under CBS, branch which had released the payment against a fraudulent withdrawal, should file a Police complaint.

14.10 HOLDER AND HOLDER IN DUE COURSE

Section 8 of Negotiable Instrument Act defines 'holder' of a promissory note, bill of exchange or cheque as any person who is entitled to receive or recover amount due and has possession of the instrument in his own name. In case the note, bill or cheque is destroyed, holder is the person entitled to it at the time of such loss or destruction. Holder can either be the payee or the endorsee or the bearer of the instrument.

Section 9 of the Act defines 'Holder in due course'. Holder in due course is a person who: (a) For consideration becomes the possessor of a promissory note, bill of exchange or cheque; and (b) Payee or endorsee thereof, if payable to order, before its maturity and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

The essential qualifications of a holder in due course are:

(a) He must be a holder for valuable consideration.

(b) He must have become a holder before the date of maturity of the negotiable instrument.

(c) He must have become holder of the negotiable instrument in good faith.

(d) He should take the instrument without any negligence on his part.

(e) He must take the negotiable instrument complete and regular on face of it.

Privileges of a holder in due course:

(a) Protection against previous defects in title:

A holder in due course taking the instrument in good faith is protected against all defects of title of the person from whom he has received it. Section 53 provides that holder of a negotiable instrument who derives title from a holder in due course has rights thereon of that holder in due course. Thus holder of due course can rectify a defective title for subsequent holders as well.

(b) Rights of holder in due course not affected by inchoate stamped instrument:

Section 20 provides that where a person signs and delivers to another a paper stamped in accordance with law relating to negotiable instruments in force and either wholly blank or having written an incomplete negotiable instrument, gives prima facie authority to the holder thereof to make or complete, upon it a negotiable instrument, for any amount specified therein not exceeding the amount covered by the stamp, the person so signing will be liable upon the instrument to any holder in due course for the amount even for anything in excess of the amount intended by him to be paid there under.

(c) All prior parties are liable to holder in due course:

Section 36 provides that every prior party to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied. Thus the holder in due course has right of action against all previous parties.

(d) Right to enforce payment of a fictitious bill:

Section 42 provides that an acceptor of a bill of exchange drawn in a fictitious name and payable to the drawer's order is not relieved from liability to any holder in due course claimed under an endorsement by the same hand as the drawer's signature and purporting to be made by the drawer.

(e) No effect of conditional delivery:

Section 46 provides that in case a negotiable instrument is delivered conditionally or for a special purpose and is negotiated to a holder in due course, a valid delivery of it is conclusively presumed and he acquire good title to it.

(f) Absence of consideration or presence of an unlawful consideration has no effect on holder in due course:

Section 58 provides that if a negotiable instrument is lost or has been obtained from any maker, acceptor or holder thereof by means of offence or fraud or for an unlawful consideration, no possessor or endorsee claiming through the person who found or obtained the instrument is entitled to receive the amount due upon it from such maker, acceptor or holder or from any party prior to such holder. The said norm is not applicable if such possessor or endorsee is or the person through whom he claims was a holder in due course.

(g) Estoppel against denying original validity of instrument:

Section 120 provides that no maker of a promissory note and no drawer of a bill of exchange or cheque and no acceptor of a bill of exchange for honor of drawer shall on proof of protest presume fact of dishonour unless the validity of the instrument as originally made or drawn.

(h) Estoppel against denying capacity of the payee to endorsee:

Section 121 provides that no maker of a promissory note and no acceptor of a bill of exchange or cheque and no acceptor of a bill of exchange payable to order shall in suit by a holder in due course be permitted to deny the payee's capacity at the rate or the note or bill to endorse the same.

(i) Estoppel against endorser to deny capacity of parties:

Section 122 provides that no endorser of a negotiable instrument shall in a suit by a subsequent holder be permitted to deny the signature or capacity to contract of any prior party to the instrument.

In *U. Ponnappa Moothan Sons, Palghat* v. *The Catholic Syrian Bank Ltd.* [JT 1990 (4) SC 94], Court had to interpret Section 9 of the Negotiable Instruments Act 1881 defining 'Holder in due Course'. Plaintiff bank was providing credit facilities to the defendant firm having 3 partners. A promissory note was executed by the Defendant in favour of their mother and the same was endorsed in favour of the Plaintiff as security for the facilities provided to the defendant firm. Cheques were purchased by the Plaintiff bank from the defendant firm for valid consideration and proceeds were credited to the account of the defendant firm who withdrew the money at different times. The cheques were sent by the Plaintiff bank for collection but the same were returned with the endorsement "full cover not received". Suit was filed for recovery of amount due. Court held that plaintiff is a 'holder in due course' and is entitled to enforce liability against the maker of the cheque. It was further held that the Indian definition of 'holder of due course' under the Negotiable Instruments Act 1881 is more stringent than Section 29 of U.K Bills of Exchange Act 1882. Under the Indian law, the holder needs to have acquired the bill, note or cheque for valid consideration. Also, the holder should not have sufficient cause to believe that there is any defect in the title of the person from whom he derives his title. The holder should act in good faith and with reasonable caution. The court has to decide whether the negligence on part of the holder is so gross and extraordinary to presume that the holder had sufficient cause to believe that the title was defective. The words "without having sufficient cause to believe" have to be interpreted

in the light of facts and circumstances of the case. It was held that the Plaintiff had discharged the necessary burden and was a holder in due course for valid consideration.

14.11 CHEQUES FOR THIRD PARTIES

A third party cheque is one which is written by one party for another and subsequently it is given to a third party whose name is added to it. Such cheques have to be endorsed by the original payee with their signature. As per Reserve Bank Circular DBOD.BP.BC.No.32 /21.01.001/2009-10, practice of collection of cheques crossed 'account payee' through third party accounts (of co-operative credit societies) is not permissible. Sub-members of clearing houses may collect cheques of their customers for the credit to their accounts through the sponsor member, under certain circumstances referred to therein.

To mitigate difficulties faced by the members of co-operative credit societies in collection of account payee cheques, collecting banks may consider collecting account payee cheques drawn for an amount not exceeding ₹ 50,000/- to the account of their customers who are co-operative credit societies, if the payees of such cheques are the constituents of such co-operative credit societies. Collecting bank shall carry out proper due diligence with respect to such co-operative credit societies. They should be aware that in case of a claim by true owner of cheque, rights of the true owner of the cheque are not in any manner affected by the circular and banks will have to establish that they acted in good faith and without negligence while collecting the cheque in question.

14.12 NEGOTIATION

When a promissory note, bill of exchange or cheque is transferred to any person, so as to continue that person the holder thereof, the instrument is said to be negotiated. (Section 14, Negotiable Instruments Act). The Act provides the following norms on negotiation.

(a) A promissory note, bill of exchange or cheque payable to bearer is negotiable by the delivery thereof (Section 46).

(b) A promissory note, bill of exchange or cheque delivered on condition that it is not to take effect except in certain event is not negotiable except in the hands for value without notice of the condition unless the event happens (Section 47).

(c) A promissory note, bill of exchange or cheque payable to order is negotiable by the holder by endorsement and delivery thereof (Section 48).

(d) Every sole maker, drawer, payee or endorsee or all of several joint makers, drawers, payee or endorsees of a negotiable instrument may if negotiability of such instrument has not been restricted or excluded, endorse and negotiate the same (Section 51).

(e) Writing on a negotiable instrument is not valid for the purpose of negotiation if such writing purports to transfer only a part of the amount appearing to be due on the instrument. If such amount has been partly paid a note to that effect may be indorsed on the instrument and can be negotiated for the balance (Section 56).

14.13 RULES OF EVIDENCE

Section 136 of the Negotiable Instruments Act states that if a negotiable instrument is made, drawn, accepted or endorsed outside India but in accordance with law of India, the circumstance that any agreement evidenced by such instrument is invalid according to the law of the country wherein it was entered into does not invalidate any subsequent acceptance or endorsement made thereon within India. Evidence of complainant of dishonour of cheque can be given on affidavit and such evidence can be read in any enquiry, trial or other proceeding (Section 145). In case of proceeding for dishonour of cheque, Court shall on production of bank's slip or memo having thereon the official mark denoting that the cheque has been dishonoured, presume the fact of dishonour of such cheque, unless and until such fact is disproved (Section 146).

As per Sections 118 and 119, the following presumptions shall be made for negotiable instruments of consideration.

(a) Every negotiable instrument was made or drawn for consideration and every instrument when it was accepted, indorsed, negotiated or transferred was accepted, indorsed, negotiated or transferred for consideration.

(b) Every negotiable instrument bearing a date was made or drawn on such date.

(c) Every accepted bill of exchange was accepted within a reasonable time after its date and before its maturity.

(d) Every transfer of negotiable instrument was made before its maturity.

(e) Endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

(f) A lost promissory note, bill of exchange or cheque was duly stamped.

(g) Holder of a negotiable instrument is a holder in due course, provided if the instrument has been contained from its lawful owner or from any person in lawful custody thereof by means of an offence or fraud or for unlawful consideration, the burden of proving that the holder is a holder in due course lies upon him.

(h) In suit upon an instrument which has been dishonoured, Court shall on proof of protest presume fact of dishonour, unless and until such fact is disproved.

In *Bharat Barrel and Drum Manufacturing Company* v. *Amin Chand Payrelal* [AIR 1999 SC 1008], Defendant admittedly executed a promissory note. A suit was instituted by the Plaintiff on failure of Defendant to repay the amount. In defence, the defendant took the plea that the note was executed as a collateral security to a contract which could not be executed due to change in circumstances and the defendant owed no liability towards the Plaintiff. The Court held that once execution of a promissory note is admitted, presumption under section 118(a) of the Negotiable Instruments Act 1881 would come into play that the same was executed for consideration. This presumption is rebuttable and the defendant can discharge it by taking up a suitable defence. If the defendant is successful in doing so, the burden of proof once again shifts upon the Plaintiff. The court held that the defendant has to bring such facts and circumstances on record that lead the court to conclude that there was no consideration.

Section 120 to 122 provides for three kinds of estoppels in case of negotiable instruments.

(a) Estoppel against denying original validity of instrument.

(b) Estoppel against denying capacity of payee to endorse.

(c) Estoppel against denying signature or capacity of prior party.

14.14 PAYMENT AND INTEREST

Section 78 provides that payment of the amount due on a promissory note, bill of exchange or cheque has to be made to the holder of the instrument to discharge the maker or acceptor. If interest at a specified rate is expressly made payable on a promissory note or bill of exchange, interest shall be calculated at the rate specified, on the amount of the principal money due thereon, from the date of instrument, until tender or realization of such amount or until such date after institution of suit to recover such amount as Court directs (Section 79). If no rate of interest is specified in the instrument, interest on the amount due thereon shall be calculated at the rate of eighteen per cent per annum from the date at which the same ought to have been paid by the party charged, until tender or realization of the amount due thereon or until such date after the institution of a suit to recover such amount as Court would direct (Section 80).

14.15 SUMMARY

A banker is bound to honour the customer’s cheque subject to certain conditions. In case a bank fails to fulfill this duty, subject to satisfaction of other conditions, bank will be liable for wrongful dishonour of the instrument. Wrongful dishonour of negotiable instruments due to negligence or mistake amounts to deficiency in services and the banker is

liable to compensate for the same. While the banker is liable for wrongful dishonor of a negotiable instrument, in certain cases, he can refuse payment and in such cases the refusal to honour the negotiable instrument is not wrongful. Sections 10, 85 and 128 of the Negotiable Instruments Act provide for the statutory protection of the banker.

The forgery and fraud of the customer cheques are also common in banking business. The Reserve Bank has come out with strict guidelines to deal with forgery and fraud to protect the consumer interests. Overdraft facilities are provided by banks for a fee. Under this facility, the customer can withdraw money from his account, despite having zero balance. It is a credit facility provided by the bank. Section 9 of the Act defines ‘Holder in due course’. Holder in due course is a person who for consideration becomes the possessor of a promissory note, bill of exchange or cheque or a payee or endorsee thereof, if payable to order, before its maturity and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

14.16 KEY WORDS

1. Cheque
2. Overdraft agreement
3. Stale Cheque
4. Payment in due course
5. Forgery
6. Holder
7. Holder in due course
8. Third Party Cheque
9. Negotiation
10. Payment
11. Interest
12. Customer
13. Dishonour
14. Banker
15. Fraud.

14.17 SELF ASSESSMENT QUESTIONS

1. Define the following- Negotiation, Holder, Holder in due Course.

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2. Discuss the law relating to overdraft agreements and stale cheques.

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3. What are the advantages available to a 'holder in due course'?

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4. Elaborate upon the statutory protection available to the banker.

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5. What are the consequences of wrongful dishonour of cheques? When is such dishonour permissible?

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14.18 REFERENCES

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UNIT-15: BANKER AND CUSTOMER RELATIONSHIP

Structure:

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15.0 OBJECTIVES

1. To understand the special customers of banks and their relations with the banks.
2. To highlight other services provided by banks such as locker services and financial advice.

15.1 INTRODUCTION

Depending upon the transactional attributes, the relation between banker and customer can be either of a debtor and creditor, principal and agent, pledgor and pledgee, mortgagor and mortgagee or of a trustee and beneficiary. Further, depending upon the nature of relationship between the two, mutual rights and duties vary. The principal relationship between banker and customer is that of debtor and creditor, while all other relationships are special type of relationships.

The debtor and a creditor relationship imposes special obligations on the banker. The banker is under an obligation to honour the cheques of the customer. In case of default, banker must compensate the drawer for any loss or damage caused by such default. Banker is also under an obligation to maintain secrecy of accounts as previously discussed. However, the banker has number of rights against the customers. These include the right to return cheques not properly drawn or not submitted within proper time, return of deposit if not in proper manner and time, right of set-off and lien, right to credit the account of the customer for any recoverable dues etc. The customer also has a number of rights against the banker. These include the right to deposit money in his account and ask for repayment, demand statement of account, claim interest on deposit etc. Customer can ask for damages in case of wrongful dishonour of instrument or in case of non-payment over instrument made in due course. Customer can also issue instructions and stop payment of cheques. Customer at the same time is bound to obey the laws in force and pay all the legal charges, dues of the bank. Payment must be demanded in proper format during proper time and in proper manner. The money must be deposited properly and in time. Further, cheque books issued by banks are to be kept in safe custody and any loss of cheque book or cheque leaf has to be informed to bank to prevent any forgery or fraud. This mutual relationship of banker and customer can come to an end either at will or by operation of law.

In *Indian Overseas Bank* v. *Industrial Chain Concern* [JR 989 (4) SC 334], Court held that till a bank account is opened no banker-customer relationship comes into existence between the bank and the person interested in opening an account. Once account is opened, mutual rights and liabilities are created under law.

15.2 SPECIAL CATEGORIES OF CUSTOMERS

Besides the regular customers, banks have a number of special customers. These include minors, company, unincorporated bodies, trust, Hindu Undivided Family, Foreigners, Non Resident Indians etc. the norms applicable in case of these customers differ from the ones applicable to the regular ones. A brief discussion of few of the special customers of bank is undertaken below.

15.2.1 Company

Section 3 of Companies Act 1956 defines a company as ‘a company formed and registered under this Act’. Companies are artificial entities created under law having perpetual succession and the right to hold property and enter into contract in its name. Company can either be private or public. For a company to open a bank account, the bank insists upon a number of documents. These include, (i) Certified copies of memorandum of association and articles of association; (ii) Copy of Certificate of incorporation and commencement of Business; (iii) Certified copy of resolution of Board of Directors for opening of bank account; (iv) List of present directors of the company under the signature of the Chairman; (v) Certified Copy of resolution of general body of shareholders showing appointment of the name directors.

Banks have to very carefully scrutinise the documents submitted by the company. The Memorandum of Association is a vital document in this regard. Memorandum of Association should be specifically seen for verifying the information relating to; (i) Name and address of the registered office of the company; (ii) Name and address of the directors; (iii) Powers of the company and business activities which can be undertaken by the company; and (iv) Powers of the Company directors to borrow, create charges, give guarantees etc.

The banks have to be extra vigilant in three aspects, while dealing with a company’s account. First, cheques payable to companies should not be credited to personal account of company’s directors, managers or employees. Second, the director of the said company is not insolvent thereby creating a bar upon operation of account by him. Third, no winding up proceeding has been initiated against the company. Upon commencement of winding up proceedings, directors lose power to operate company account.

In *Bilakchand Gyanchand Co.* v. *A. Chinnaswami* [AIR 1999 SC 2182], a cheque issued by the managing director on behalf of a company was subsequently dishonoured for want of funds. The issue which arose before the court was whether service of notice under section 138 of the Negotiable instruments Act 1881 to the managing director was sufficient

compliance if a notice was not sent to the company itself. The Court held that the proceedings were initiated against the Managing Director. Also, the cheques which were dishonoured were signed by him. Under these circumstances there was no defect in the notice issued under section 138, which was sent to the managing Director who was a signatory of the cheques.

15.2.2 Sole Proprietorship

Proprietorship firms can open current account which can be operated by the proprietor himself or a duly authorised agent. These accounts are very similar to individual accounts and banks usually insist upon a declaration of status from the proprietor.

15.2.3 Partnership Firms

Section 4 of the Indian Partnership Act 1932 defines a partnership as “the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all”. Partners are defined as “Persons who have entered into partnership with one another are called individually, ‘partners’ and collectively ‘a firm’, and the name under which their business is carried on is called the ‘firm-name’. Section 5 of the Act provides that members of a Hindu undivided family carrying on a family business are not partners. Section 6 details the mode of determining existence of partnership. It provides that in determining whether a group of persons is a partnership or not or whether a person is a partner in a firm or not, the real relation between the parties should be taken into account. As partnerships need not be compulsorily registered, banks have to ascertain the nature of partnership to see whether it actually fulfils the criteria of being a partnership prior to opening an account for an unregistered partnership.

Some of the key features of bank accounts opened in the name of partnerships are:

(a) If the partnership is registered, banks should insist upon submission of a copy of registration certificate.

(b) Other than saving bank account, all types of bank account can be opened by a Partnership.

(c) If partner is illiterate and affixes thumb impression, such thumb impression has to be attested by a Magistrate.

(d) The bank account is opened in the name of the firm and not the individual partners.

(e) Banks have to ascertain details about operation of bank account. The said account can be operated by all the partners jointly, few of the partners named or by a third party under a power of attorney signed by all the partners.

(f) As the partners are jointly and severally liable, partners have to put in their signature both in their individual capacity and as partners.

(g) Cheques drawn in favour of partnership firm should not be credited to the personal account of the partner. Also, cheques payable to a partner should not be credited to the firm's account unless duly authorised by other partners.

(h) In case of retirement of a partner, a new account of the firm is to be opened with the then existing partners. The old account is to be closed. In case a new partner joins, his name must be included in the firm name.

(i) Cheques drawn up by a partner before his death but submitted for payment after his death must be cleared only after making inquiries with the surviving partner.

(j) Banks should not allow operation of account in case of firm dissolution. Dissolution can be either by mutual agreement between the partners, by notice of dissolution in case of partnership at will, by operation of law in the cases like insanity, incapacity death or insolvency of the partner.

15.2.4 Hindu Undivided Family (HUF)

Hindu Undivided Family consists of all persons lineally descended from a common ancestor, including wives and unmarried daughters. All ancestral properties belong to a Hindu undivided family. The right to manage the family property vests in the 'Karta' of the family. The senior most member of the family acts as the Karta. Previously only males could act as Karta. Now, even females can be Karta. The Karta has power to create charge over ancestral property. This interest has to be exercised in the interests of family welfare. Personal properties of the members of the Hindu undivided family are not bound by acts of the Karta. Only ancestral property of the other members can be made liable by acts of the Karta.

In case of opening an account of Hindu undivided family, bank has to keep the following points in mind:

(a) Account is opened in the name of Karta.

(b) HUFs engaged in trading activities cannot open saving banks account.

(c) The account opening form has to be signed by all the members of the HUF.

(d) Usually only Karta can operate the bank account.

(e) In case of necessity, Karta can appoint any adult coparcener to operator the bank account. The designation of the coparcener so appointed will be that of 'Manager' of the HUF.

(f) Other members of the HUF can operate the account if the Karta gives a letter of authority to that effect.

15.2.5 Unincorporated Bodies

Unincorporated bodies such as clubs, association etc. can also open bank accounts. However, as these bodies have no legal entity banks should be extra cautious before going ahead with account opening. Besides, the regular procedure, banks should check the rules and regulations governing such unincorporated bodies. They should also look into certified copy of the resolution passed by the Governing Body for opening up the bank account. Name of persons authorised to operate such account and genesis of authority should also be verified.

15.2.6 Trust

Section 3 of the Indian Trusts Act 1882 defines a trust as "an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner". The law provides that Trusts have to be compulsorily registered under the applicable State Law. The said registration is done by Charity Commissioner. The registration certificate obtained post completion of procedure of registration is conclusive of the particulars contained in it. The registration certificate is a very vital piece of document to be considered by the bank while considering opening of a bank account in the name of the trust and banks should insist upon submission of a certified copy of the same. Other vital documents to be collected by the bank before opening an account in the name of the trust include the following:

(a) Copy of constitution of trust and trust deed (if any).

(b) List of current trustees and appointing authority.

(c) Copy of General resolution passed by trustees for opening of a bank account.

(d) Certified copy of the latest entry in the public trusts register (Public Trust Registration).

(e) Account opening form must be signed by all the trustees.

(f) A resolution passed by trustees specifying the name of the bank.

(g) Name of the members operating the account. Usually name of persons operating the trust account at large.

(h) Indemnity agreement, indemnifying the bank for operations on the trust account. Such bond has to be signed by all the trustees.

(i) Order from Charity Commissioner allowing the bank to carry operations on the trust account.

15.2.7 Joint Account Holders

Section 45 of the Indian Contracts Act 1872 lays down the law relating to joint account. It provides that "When a person has made a promise to two or more persons jointly, then, unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and, after the death of any of them, with the representative of such deceased person jointly with the survivor or survivors, and, after the death of the last survivor, with the representatives of all jointly." Joint accounts are accounts opened in the name of two or more individuals. In case of such accounts, the Account Opening Form is signed by all the joint account holders. Some of the key points to be kept in mind while opening such accounts are:

(a) Banks should obtain specific information on Account Operation, Repayment of balance etc.
(b) Generally all joint account holders can jointly authorise account operations.
(c) In case of account closure or maturity of bank deposit, banks should specifically follow the instructions provided at the time of account opening or making deposit.
(d) In case of notice of death, insolvency or insanity of one of the account holders, the operations of the account must be stopped.
(e) Account holders can nominate one person. In case of absence of nomination, balance amount is paid to surviving account holder and the legal heirs of the account holders.
(f) Cheques payable to the account holders jointly cannot be credited to the personal account of any holder.
(g) In case of dispute with bank, the account holders have to provide a new mandate mutually acceptable to all parties.
(h) Account holders can issue directions contrary to the instructions provided to the bank previously.
(i) Joint account holders cannot borrow, overdraw or discount bills of exchange unless there is an express agreement to this effect between the joint account holders and the bank.

15.2.8 Minors

The Indian Majority Act 1875 and the Guardian and Wards Act 1890 define minor as a person below the age of eighteen years. In case a legal guardian is appointed by court, the person attains majority on completing the age of twenty- one years. Section 11 of the Indian Contract Act 1872 provides that a contract entered into by a minor is void. He cannot be partner in a firm and also cannot be adjudged insolvent. These factors indicate the special

status granted to the minor under the law. Minor's account can be opened by; (i) Father or mother on behalf of minor. (ii) Father or mother in joint name of himself/herself and minor. (iii) Guardian appointed by Court. (iv) Minor of age 10 and above in his or her single name to be self operated. Minors can be classified into following three age groups in connection with the banking.

Minors below 10 years of age: While the account can be opened in the name of the minor, minor cannot operate the account.

Minors between age of 10 to 14 years: Such minors can open account and operate it independently.

Minor of 14 years of age and above: Minors in such age groups can open and operate both savings and current account.

15.2.9 Non-Resident Indians

Reserve Bank has frequently changed the guidelines and information regarding account facilities for Non Resident Indians (NRIs) and Persons of Indian Origin (PIOs). The most recent guidelines of the Reserve Bank passed on 17 January 2012 states as follows.

(a) Person resident outside India is a person who is not resident in India as per Foreign Exchange Management Act 1999.

(b) NRI/PIO of Bangladesh and Pakistan require approval of Reserve Bank before account opening.

(c) NRI/PIO can open a number of accounts without permission of Reserve Bank. These are:

i. Non- Resident Ordinary Rupee Account (NRO Account).

- NRO Accounts can either be current, savings, recurring or fixed.
- Such accounts have to be denominated in Indian Rupees.
- In case of savings account, banks are free to decide interest rate.
- Term deposit interest rates can also be determined by banks. However, the interest rates should not be more than that offered on comparable domestic rupee deposits.
- NRO accounts can be credited with transfers from rupee accounts of non-resident banks, remittances received in permitted currency from outside India, permitted currency tendered by account holder, dues like rent, dividend, pension, and interest etc., sale proceeds of assets acquired out of rupee/currency funds by way of legacy/inheritance.

- NRO accounts can be debited with local payments in rupees, payment for investments as specified by Reserve Bank and remittance outside of India of account holder.
- NRO account can be remitted to an amount not exceeding USD one million per financial year.
- Nomination facility is available for NRO account.
- Accounts can be held jointly with residents and/or with non-resident Indian.

ii. Non-Resident (External) Rupee Account (NRE Account)

- NRE account can be either savings, current, recurring or fixed deposit accounts.
- Account can be opened only by non-resident himself.
- NREs can open account with their resident close relatives on 'former or survivor' basis.
- Account has to be maintained in Indian Rupees.
- Balance in NRE account are freely repatriable.
- Banks are free to determine savings interest rates and interest rate of term deposits of maturity of one year and above. Interest rate cannot be higher than that offered on comparable domestic rupee deposits.
- Credits to NRE account allowed include inward remittance to India, proceeds of account payee cheques, demand drafts/bankers cheques issued against encashment of foreign currency, transfers from other NRE/FCNR accounts, sale proceeds of FDI investments, interest on Government securities/ dividends on units of mutual funds purchased by debit to the NRE/FCNR(B) account of the holder etc. Debits which can be allowed include local disbursements, transfer to other NRE/FCNR accounts, remittance outside India etc.

iii. Foreign Currency Non Resident (Bank) Account – FCNR (B) Account

- FCNR (B) accounts are in the form of term deposits of 1 to 5 years.
- Interest rate for the account is determined by Department of Banking Operations and Development, Reserve Bank.
- Account can be in any freely convertible currency.
- Terms and conditions as applicable to NRE account applies to FCNR (B) (in respect of joint accounts, repatriation of funds, opening account during temporary visit, operation by power of attorney, loans/overdrafts against security of funds held in accounts)

(d) Permission of Reserve Bank is necessary for opening account by Bangladesh/Pakistan individuals. Applications are to be made to Chief General Manager-in-Charge, Foreign Exchange Department, Foreign Investment Division, Reserve Bank of India.

(e) Individual resident Indian can borrow a sum not exceeding USD 250,000 from close relatives staying outside India. The minimum maturity period of loan should be one year and the loan should be free of interest.

(f) Individual resident can lend money by crossed cheque/electronic transfer within overall limit of USD 200,000 per financial year under Liberalised Remittance Scheme.

(g) Returning NRIs/PIOs may continue to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was acquired, held or owned when resident outside India.

(h) Person resident in India can open Foreign Currency Account while being outside India.

(i) Returning NRIs/PIOs can open a Resident Foreign Currency Account (RFC). These account can be in the form of current, savings or term deposit accounts.

(j) Individuals resident in India can include non-resident close relative(s) as a joint holder(s) in their resident bank accounts on 'former or survivor' basis.

(k) Resident individual can gift shares/securities/convertible debentures etc. to NRI close relative up to USD 50,000 per financial year.

15.2.10 Foreigners

Foreign tourists can open a bank account of their own while in India. Foreigners can open a Non-Resident (Ordinary) Rupee (NRO) account (Current/Savings). The account can be opened with any Authorised Dealer bank dealing in foreign exchange. Some of the key features of such accounts are:

(a) Account can be opened for a maximum period of 6 months.

(b) Documents such as Passport, identification proofs are necessary for opening account.

(c) NRO accounts can be credited with funds remitted from outside India or obtained via sale of foreign exchange brought to India.

(d) Foreigners can make local payment through NRO account.

(e) Payment to residents exceeding INR 50,000 is to be made through cheques/ pay orders/demand drafts.

(f) Authorised Dealer Banks can convert balance for payment to account holder into foreign currency. For this purpose, account should not have been maintained for more than six months and account should not have been credited with local funds.

(g) Applications for repatriation of balance are to be made to Foreign Exchange Department of Regional Office of Reserve Bank through Authorised Dealer Bank.

(h) Foreign nationals working in India can maintain resident accounts with an Authorised Dealer Category-I (AD Category-I) bank in India. Such accounts can be re-designated as NRO account at the time of leaving country.

15.3 OTHER TRANSACTIONS BETWEEN BANKER AND CUSTOMER

15.3.1 Safe Deposit Vaults

Banks provide safe deposits vaults or locker service to customers. While banks are able to charge for the service, the customer is assured of the safety of his valuables. The Master Circular on Customer Services in Banks passed on 1 July 2013 provides detailed guidelines on safe deposit locker services provided by banks. Few of the key guidelines are:

(a) Banks should ideally refrain from linking allotment of locker to placement of fixed or other deposit beyond permissible levels.

(b) Locker allotment procedure should be transparent. A wait list should be maintained for the purpose of allotment of lockers. Applications received for lockers should be given a wait list number if the bank is unable to provide the service immediately.

(c) Due care should be exercised by the banker for protection of customer's lockers.

(d) Customer due diligence should be carried out by the bank for both new and existing customers. In case of customers classified under higher risk category, customer due diligence as per applicable KYC norms should be carried out.

(e) For customers placed in medium and higher risk category, banks should be vigilant about locker use. If lockers are not used for more than three years for medium risk category customer and one year for higher risk category, banks should inquire into the reasons behind it and if necessary can ask for surrender of locker. Suitable clause to that effect should be incorporated into the locker agreement entered into between the bank and the customer.

(f) Banks should put in place a legal procedure for breaking open lockers and taking stock of inventory under defined conditions.

(g) Lockers keys should be embossed with Identification Code of the bank/branch.

(h) A set procedure should be provided for return of locker contents to survivor/nominee/legal heir of the customer in appropriate circumstances.

(i) Due diligence and caution should be exercised by the bank in establishing the identity of the survivor/nominee. Documentary evidence should be obtained about the death of the locker hirer.

(j) In case of lockers without a survivor/nominee clause, banks should adopt a customer friendly procedure for giving access to legal heir/ legal representative of the deceased locker hirer.

(k) An inventory should be prepared before return of articles left in safe custody.

15.3.2 Financial Advice

Banks nowadays are providing a number of services outside the realm of traditional banking services. One of them is providing financial services. Most banks today, especially multinational ones provide financial services, advising their clients on investment of their funds, depending upon their financial goals and financial strength. Banks are creating wings with financial advisors exclusively designed to provide such services wherein stock is taken of the financial condition of a customer, future plans, liabilities etc. and based upon information provided, customers are advised as to how they should invest their money including diversification of their portfolio, tax planning, protection of investments, retirement plans, having adequate liquid assets in hand etc. For providing these services, banks charge either an advisor fee or commission or a combination of both. As regards customers, they are able to avail of expert knowledge with a personalised advisor advising them. Often implementing a detailed financial plan is worked out keeping in mind the requirement of the customer.

15.3.3 Lien- Power to Combine Different Accounts

Lien is the right to retain possession of something for fulfilment of the demands of the person in possession. When the power is exercised as regards certain specific goods or articles, it is specific lien otherwise it is general lien. A banker too has a general right of lien. Section 171 of the Indian Contract Act 1872 provides for the general power of lien. However, this power is subject to any express or implied contract to the contrary which may be entered into between the banker and the customer. It provides "Bankers... may, in the absence of a contract to the contrary, retain as a security for a general balance of account, any goods bailed to them."

One incident of this power is the right of the bank to combine or consolidate accounts with any liabilities to the bank. Bank has the right to set off any sum of the customer available with the bank towards satisfaction of any liability which the bank may owe. Such liability can be actual or contingent, primary or collateral and joint or several. This right of the bank may not always run contrary to the interest of the customer. In case the customer having multiple accounts in a bank- say a savings account, a current account and a credit card facility and the customer is short of funds in one account, the bank can clear the debt of the customer by taking funds from the other account wherein funds are available. At times, it could save the customer from paying extra charges or interest which would otherwise be levied in case of default.

For the right of set- off to be exercised, two essential conditions must be fulfilled. Firstly, the accounts must be held by the customer in the same capacity. Thus obligations arising under an account held as a trustee cannot be set off against an account held in personal capacity. The customer is however, free to enter into a contract to the contrary and authorise the banker to utilize funds held by the customer in different capacities for payment of obligations arising under any account. Secondly, the obligation to be set- off must have actually arisen or in other terms some payment must be due. Future liabilities or expected liabilities cannot be set –off by the banker in anticipation of a purported lack of funds.

15.4 SECRECY OF ACCOUNTS

The Banker is under an obligation to maintain secrecy of accounts. Unauthorised disclosure of account details by banker is prohibited. The banker is in a position of trust and is entrusted with information about the financial health of the customer. Financial health of a customer directly affects his reputation and therefore the banker is obliged to maintain absolute secrecy about it. This obligation continues even after the account is closed or upon death of the customer. However, this obligation is subject to certain exceptions. The Master Circular on Customer Service in Banks states this obligation under paragraph 25 titled as 'Customer Confidentiality Obligations'. It provides that Indian law on banker's obligation to maintain secrecy primarily arises from common law principle based on implied contract. Certain exceptions to the obligation are provided. These are:

(a) Disclosure under compulsion of law;

(b) Situations where there is a duty to disclose to public;

(c) Disclosures required in the interest of banks and

(d) Disclosures made with the express or implied consent of customer.

Further, information collected from customers at the time of account opening or for KYC compliance are confidential and are not to be used for any other purpose such as cross selling of bank services. The Committee on Procedures and Performances Audit on Public Services (CPPAPS) has strictly advised against this trend.

15.5 PASSBOOOK AND ENTRIES MADE THEREIN

Master Circular on Customer Service in Banks describes a passbook as a ready reckoner of transactions. The Circular lists down its advantage in comparison to a statement of account. These are:

(a) Statements need to be filed regularly.

(b) Opening balance of Statement needs to be tallied with closing balance of last statement.

(c) Loss of statements in postal transit is common.

(d) Obtaining duplicate of statement is expensive and inconvenient.

(e) Large number of customers do not have access to computers/Internet.

Citing these reasons, the Circular advises banks to offer passbook facility to all its savings bank account holders. For customers who choose to get statement of account, banks have to send monthly statement of account. Further, the circular provides that customers should not be charged the cost of providing Passbook or Statement.

Paragraph 5.6.2 of the Master Circular lays down norms on updating passbooks. It provides:

(a) Customers should be made aware of the need to get the pass-books updated regularly.

(b) Bank employees have special responsibility in customer awareness.

(c) If pass-books are held back for updating, paper token mentioning the date of receipt and date of collection should be issued.

(d) If pass-book is submitted for updating after a very long time or after large number of transactions, printed slip requesting depositor to submit it periodically for updation should be given.

Paragraph 5.6.3 of the said Master Circular lays down norms on entries in passbooks/ statement of accounts. It provides; (i) Banks should be very careful about entry of correct and legible particulars in pass books. (ii) Banks should avoid inscrutable entries in pass books. (iii) Entries should have brief, intelligible particulars.

Paragraph 5.6.4 lays down norms on maintenance of saving bank pass books. Harping upon need for maintenance of pass books, it cautions that negligence in taking adequate care of savings bank pass books can lead to fraudulent withdrawal from relative accounts. Three

main precautions mentioned are; (i) Branches should accept pass books and return them against tokens. (ii) Pass books should be kept in the custody of named responsible bank officials. (iii) While at the branch, pass books should be kept under lock and key overnight. Paragraph 4.3 provides that pass books should be made available in trilingual form i.e., English, Hindi and the concerned Regional Language.

15.6 SUMMARY

Depending upon the transactional attributes, the relation between banker and customer can be either of a debtor and creditor, principal and agent, pledgor and pledgee, mortgagor and mortgagee or of a trustee and beneficiary. Further, depending upon the nature of relationship between the two, mutual rights and duties vary. The principal relationship between banker and customer is that of debtor and creditor while all other relationships are special type of relationships. Besides the regular customers, banks have a number of special customers. These include minors, company, unincorporated bodies, trust, Hindu Undivided Family, Foreigners, Non Resident Indians etc. the norms applicable in case of these customers differ from the ones applicable to the regular ones. Besides providing regular services of accepting deposits and advancing loans, banks also provide a number of special services such as safe deposit vaults and financial advice.

15.7 KEY WORDS

1. Company
2. Sole Proprietorship
3. Partnership firms
4. Hindu Undivided Family
5. Unincorporated Bodies
6. Trust
7. Joint Account Holders
8. Minors
9. Non Resident Indians
10. Foreigners
11. Safe Deposit Vaults
12. Financial Advice
13. Passbook
14. Secrecy
15. Lien.

15.8 SELF ASSESSMENT QUESTIONS

1. Discuss the norms to be followed in the following categories of special type of bank customers-

   (a) Company

   (b) Minor

   (c) Unincorporated Bodies.

   (d) Trust

   (e) Foreigners

   (f) Partnership Firms.

   (g) Sole Proprietorship

   (h) Hindu Undivided Family.

   (i) Non Resident Indians.

2. Elaborate upon the services provided by banks with reference to the safe deposit vaults and financial advice.

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3. Evaluate the norms governing passbooks and entries made therein.

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15.9 REFERENCES

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BLOCK - IV

UNIT-16: LOANS AND ADVANCES

Structure:

16.0 Objective

16.1 Introduction

16.2 State policy on loans and advances

16.3 Priority sector advances and socio-economic policies

16.4 Self employment schemes

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16.11 How the banker profitably uses the funds?

16.12 Call loans and loans repayable at short notice

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16.15 Summary

16.16 Keywords

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16.0 OBJECTIVES

- To understand the policies and norms underlying advancement of loans.
- To know the role of banking in facilitating women entrepreneurship, socio-economic development, small scale industries, agriculture, export and rural development.
- To able to know the restrictions upon banks' use of funds and need for such regulatory regime on bank's deployment of funds.

16.1 INTRODUCTION

As previously discussed, banks accept deposits from people and also advance loans. This is one of the primary functions of banks. Both the deposits accepted and loans advanced come from a broad section of the society. Among these, loans made to traders and businessmen account for the main commercial activity of the bank. Usually the rate of interest provided on the deposits received by the banks is much less than the rate at which banks satisfies the monetary requirements of traders, businessmen and industrial enterprises. This difference in the rate of interest is the main source of earning of the bank. Again, availability of banks as a monetary institution for satisfying the short and long term monetary needs of business enterprises forms the backbone of any financial system making it possible for trade and other commercial activities to carry on.

Loan (in the context of money) refers to borrowing of some money by one person from another. The said amount borrowed is known as the loan amount. The person/entity lending the amount is known as the lender and the person/entity receiving it is borrower. Loan is basically a debt by the lender to the borrower and is usually given for a defined time period at a pre-determined rate of interest. Advance is a 'credit facility' made available by bank usually for short term (one-two years). While in case of loan, there is a sense of debt, an advance is a facility provided by banks to the borrower. Use of 'advance' facility by borrower is resorted to for meeting short term monetary requirements for meeting short term trading liabilities etc. However, as the practical implications of both 'loans' and 'advances' is the same that is, both have to be repaid and banks charge an interest, both the terms are used interchangeably.

Repayment of the loans and advances lent by banks is a key issue for banks and banks look into a number of factors before advancing these loans and advances. The primary concern of the bank is with the creditworthiness of the borrower. Credit worthiness of the borrower is the indicator of the financial soundness of the borrower and is determined on the basis of a number of factors, which vary from borrower to borrower. This is a subjective

opinion formed by the bank and could include taking into consideration past borrowing and repayment history of the borrower, physical assets of the borrower and cash flow of the company.

Security available for securing loan and the quality of such security is another key issue pondered by banks and other financial institutions before providing loans. In case of a secured loan, banks have the option of attaching the assets in case of default. Security could be in the form of tangible or intangible assets. Tangible assets would include stock in trade, immovable property, movable property etc. Intangible assets would primarily include intellectual property rights. The loans may be demand loans or medium and long term loans. A demand loan is a loan repayable at a short notice on demand. Such types of loans are usually raised to meet the working capital needs of businesses and are offered against some security, which might include shares, stocks or any other asset of company. The loan amount is disbursed at one go with borrower repaying the loan amount as per agreement with the bank either at one go or in instalments. Medium and long term loans are known as term loans. These loans are almost always issued against some security and are taken for some medium or long term goals such as modernization or expansion of existing unit, purchase of immovable assets, start-up capital etc.

16.2 STATE POLICY ON LOANS AND ADVANCES

Regulation on loans and advances is contained in the Banking Regulation Act 1949 (primarily Section 19 and 20) and the Reserve Bank Circulars on loans and advances. Section 21 of the Banking Regulation Act 1949 provides that the Reserve Bank in public interest or in the interests of depositors or banking policy can determine the policy relating to advances to be followed by banking companies, and banking companies are bound to follow the policy so determined. Reserve Bank has power to give directions relating to; (a) The purposes for which advances may or may not be made, (b) Margins to be maintained in respect of secured advances, and (c) Rate of interest or other terms and conditions on which advances or other financial accommodation may be made. Some of the key provisions contained in the Master Circular and the relevant Acts are discussed hereunder.

Advances against bank's own shares: As per Section 20(1) of banking Regulation Act, 1949 banks cannot grant loans and advances on the security of its own shares.

Advances to bank's Directors: Banks cannot grant loans and advances to or on behalf of any of its directors, or any company/firm in which any of its directors are interested as a partner, manager, employee or guarantor.

Loans and advances for this purpose shall not include; (i) Loans and advances against Government securities, life insurance policies or fixed deposits. (ii) Loans or advances to the Agricultural Finance Corporation Ltd. (iii) Call loans. (iv) Credit limit granted under credit card facility provided to its directors.

However, loans and advances include the purchase of or discount of bills from directors and their concerns, and issuance of guarantees and opening of letter of credits on behalf of bank's directors.

Restrictions on holding shares in companies: Section 19(2) of Banking Regulation Act 1949 prohibits banks from holding shares in any company except as provided in sub-section (1) whether as pledge, mortgagee or absolute owner of any amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less.

Financial Assistance to industries Producing/Consuming Ozone Depleting Substances: Banks are prohibited from providing loans and advances for setting of new units consuming/producing Ozone Producing Substances (ODS) such as Chloroflorocarbon-11, Chloroflorocarbon-12, Halons -1211, 1301, 2402 etc.

Advances to individuals: Banks can grant advances to individuals against security of shares, bonds or debentures. Limit per individual shall not exceed Rs.10 lakh and Rs.20 lakh, if the securities are held in physical and dematerialized form respectively. Banks are free to come up with their own loan policy for grant of advances to different individuals against shares, debentures or bonds. Such policy should however be in conformity with Reserve Bank guidelines.

Restrictions on Advances against Sensitive Commodities under Selective credit Control (SCC): Reserve Bank, in exercise of powers conferred under Section 21 and 35A of Banking Regulation Act 1949, can if it is necessary in public interest issue directives to banks stipulating restrictions on bank advances against specified sensitive commodities. Sensitive commodities would include food grains (cereals and pulses), major oil seeds indigenously grown (groundnut, mustard, cottonseed, castor seed), imported oils, vegetable oils, raw cotton, kapas, sugar/gur/ khandsari and cotton textiles (cotton yarn, man- made fibres, yarn and fibres made out of man- made fibres and partly out of cotton yarn and partly out of man-made fibres.

Advances to Share and Stock Brokers/Commodity brokers: Share and Stock brokers/commodity brokers can be provided with need based over-draft facilities/line of credit against shares and debentures held by them as stock-in-trade.

Loans and advances for Market Makers: Market makers approved by Stock Exchanges can be provided with loans and advances. Market making can be both for equity and debt securities. Banks are free to lay down their own loan policy in this regard.

Advances against Fixed Deposit Receipts (FDRs) issued by other Banks: Banks should desist from granting advances against FDRs or other term deposits of other banks.

Loans against Certificate of Deposits (CDs): Banks cannot grant loans against CDs. They are also not allowed to buy-back their own CDs before maturity.

Loans and Advances against Indian Depository receipts (IDRs): Banks cannot grant loans/advances for subscription to Indian Depository Receipts (IDRs). Also, banks are not allowed to grant any loan/advance against security/collateral of IDR issued in India.

Advances against Bullion/Primary Gold: Banks are prohibited from granting any advance against bullion/Primary gold. Banks should also desist from granting advances to silver bullion dealers.

Advances against Gold ornaments & Jewellery: Banks while granting advances against jewellery can give preferential treatment to hallmarked jewellery and accordingly decide on the margin and the rate of interest upon it.

Loans and Advances to Micro and Small Enterprises (MSEs): MSE units having working capital limits of up to Rupees five crores from banking system should be provided working capital finance.

Issue of Bank Guarantees in favour of other banks/Financial Institutions: Banks can provide guarantee for loans provided by other banks/financial institutions etc. However, such guarantee can only be provided for availing additional credit by borrower customer.

Recovery agents engaged by Banks: Banks should have a due diligence process in place of engaging recovery agents. Due diligence process should conform to the guidelines issued by Reserve Bank. Banks should have a system to address borrower's grievances with regard to the recovery process. Loans, personal loans, credit card loans and housing loans of amount less than Rupees ten lakhs can be referred to Lok Adalats.

16.3 PRIORITY SECTOR ADVANCES AND SOCIO-ECONOMIC POLICIES

Priority sector refers to those sectors which do not get adequate credit. These are sectors which have an impact on large sections of society and are labour intensive. This makes it necessary to have special provisions for these credit deficient sectors. Need for special provisions for priority sector was voiced for the first time at a meeting of National Credit Council in 1968. In pursuance of it, Reserve Bank constituted an Informal study Group

on Statistics relating to advances to the priority Sectors in 1971. On the basis of the report of this informal group, a list of priority sectors was formalized in 1972. Initially, there was no specific target in respect of priority sector lending. In 1974, banks for the first time had to raise the share of these sectors to the level of 33 1/3 per cent (to their aggregate advances). This was subsequently revised to be increased to 40 per cent by 1985.

The different priority sectors are

(a) Agriculture
(b) Micro and Small Enterprises
(c) Education
(d) Housing
(e) Export Credit
(f) Others.

[The priority sectors are defined from time to time by the Reserve Bank and the present list provided above is as per Reserve Bank regulations as on 01 September 2012.]

For agricultural purposes, banks are directed to provide both 'Direct' and 'Indirect' Finance. Direct finance would include: (a) Loans to individual farmers engaged in agriculture and allied activities. Allied activities include dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. (b) Loans to farmers for purchasing land for agricultural purposes. (c) Loans to Primary Agricultural Credit Societies (PACS), Farmers Service Societies (FSS) and large-sized Adivasi Multi Purpose Societies (LAMPS). Indirect finance would include: (a) Loans to Producer Companies set up under part IXA of Companies Act 1956 for agricultural and allied purposes. (b) Loans to primary Agricultural Credit Societies (PACS), Farmers Service Societies (FSS) and Large-Sized Adivasi Multi- purpose Societies (LAMPS). (c) Loans to corporate and institutions engaged in agricultural and allied purposes.

Micro and small enterprises are another priority sector. Bank loans are to be provided to these enterprises if they fulfil the requirements for investment in plant/machinery/equipment as provided under the Micro and Small Manufacturing and Service Enterprises Act 2006. For micro enterprises, the investment in plant and machinery should not exceed twenty five lakh rupees and for small enterprises, the investment in plant and machinery should be more than tenty five lakh rupees but should not exceed five crore rupees. Again, for micro enterprises, investment in equipment should not exceed ten lakhs and for small enterprises, investment in equipment should be more than ten lakhs but should not exceed two crores.

Education has been denoted as another priority sector with loans to individuals for educational purposes being made available. This includes vocational courses. There is a two tier system- for study in India, educational loan up to rupees 10 lakhs can be provided and for studies abroad, loan up to rupees 20 lakh can be provided. The limit for housing loan under priority sector for individuals in metropolitan centres with population above ten lakh is up to rupees 25 lakh and in all other centers the limit is of 15 lakh.

Weaker section has been denoted as another priority sector for banks. Weaker section includes -

(a) Small and marginal farmers;

(b) Artisans, village and cottage industries where individual credit limits do not exceed ₹ 50,000;

(c) Beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY), now National Rural Livelihood Mission (NRLM);

(d) Scheduled Castes and Scheduled Tribes;

(e) Beneficiaries of Differential Rate of Interest (DRI) scheme;

(f) Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY);

(g) Beneficiaries under the Scheme for Rehabilitation of Manual Scavengers (SRMS);

(h) Loans to Self Help Groups;

(i) Loans to distressed farmers indebted to non-institutional lenders;

(j) Loans to distressed persons other than farmers not exceeding ₹ 50,000 per borrower to prepay their debt to non-institutional lenders;

(k) Loans to individual women beneficiaries up to ₹ 50,000 per borrower;

16.4 SELF EMPLOYMENT SCHEMES

A number of self employment schemes have been launched by government which are being carried on via bank machinery. A very important scheme in this regard launched in 1997 is the Swarna Jayanti Shahari Rozgar Yojana (SJSRY). Prior to launch of this scheme, there were three schemes running- Nehru Rozgar Yojana , Urban Basic Services for the Poor (UBSP) and Urban Poverty Eradication Programme (PMIUPEP). All these three schemes were subsumed and in its place SJSRY was launched. SJSRY has five main components; (i) Urban Self Employment Programme (USEP); (ii) Urban Women Self-help Programme (UWSP); (iii) Skill Training for Employment Promotion amongst Urban Poor (STEP-UP); (iv) Urban Wage Employment Programme (UWEP); (v) Urban Community Development Network (UCDN)

Out of the five components, USEP and UWSP are the two components with which banks are directly concerned. As part of USEP, urban poor beneficiaries are given help in the form of loans and subsidies for setting up self-employment ventures. Besides this, the scheme also entails providing technology, marketing and other support. As part of UWSP, groups of urban poor women are provided loans and subsidies for setting up self-employment ventures. While in case of USEP, the focus was on individuals, UWSP provides assistance to groups. Such groups are entitled to subsidy of ₹ 300,000/- or 35% of cost of project or ₹ 60,000/- per Member of the Group, whichever is less.

As per the Reserve Bank guidelines, loans granted under the scheme are to be treated as advances under priority sector. As such, applications for loans up to ₹ 25,000/- have to be disposed of within a fortnight and loan applications for amounts above ₹ 25,000/- have to be disposed of within 8 to 9 weeks. Loan applications can be rejected by the Branch managers but such cases of rejections have to be verified by the Divisional/Regional Managers. Loan applications by SC/ST cannot be rejected by branch manager but only by a higher authority. Self-Help Groups under the scheme are eligible to open Savings bank Accounts.

For rural areas, the Swarnjayanti Gram Swarozgar Yojna (SGSY) aims at helping in individuals and groups to develop self-employment ventures. This scheme has been implemented in place of the previously existing Integrated Rural Development programme (IRDP), Training of Rural Youth for Self Employment (TRYSEM). Development of Women and Children in Rural Areas (DWCRA), Supply of Improved Toolkits to Rural Artisans (SITRA), Ganga kalian Yojana (GKY) and Million Wells Scheme (MWS).

The scheme is operative from 1 April 1999, and is implemented by Commercial banks, Co-operative Banks and Regional Rural Banks. The scheme aims at helping individuals and groups to develop self employment ventures and provides for assistance in the form of loans and subsidies. Loans under the scheme are to be treated as advances under priority sector and have to be granted expeditiously. In case of rejection of loan application by a Branch manager, the reasons for rejection are to be recorded on the application form and the said application has to be returned to the sponsoring authority for any further action. Provisions for subsidy has been provided under the scheme at a uniform rate of 30 per cent of the project cost (subject to a maximum of ₹ 7,500/-). For SC/STs, a subsidy of 50 per cent of the project cost subject to a maximum of ₹ 10,000/- is provided. These subsidies are interest free and the loans disbursed by banks are to be refinanced from NABARD. We also have the National Scheme for Liberation and Rehabilitation of Scavengers (NSLRS). This scheme is

being implemented by all public sector banks since 1993 and is aimed at improving the conditions of scavengers and their dependents. The scheme contains provisions for capital subsidy and concessional loans besides other provisions.

16.5 DRI

Differential Rate of Interest Scheme (DRI) was introduced in India in 1972 on the recommendations of Dr. B.K. Hazare chaired RBI Committee, and is implemented by all Indian Scheduled Commercial banks. Initially, implementation started with public sector banks but later private sector banks also volunteered. At present the scheme is being implemented all over India. Under the DRI scheme, individuals belonging to weaker sections of the society are given loans at concessional rate of 4 per cent per annum without insisting upon security. The beneficiaries include marginal farmers, carpenters, rickshaw pullers, physically challenged persons etc. Loans advanced under the scheme are covered by the Deposit Insurance and Credit Guarantee Corporation of India (DICGC). To avail this scheme, a number of eligibility criteria are provided which are revised from time to time.

(a) Commercial banks have to advance 0.5 to 1.00 per cent of their aggregate lending towards implementation of this scheme.

(b) The scheme provides for an income ceiling for eligibility. In urban and semi-urban areas, annual income of the beneficiaries should not exceed ₹ 7,200 and of those in rural areas should not exceed ₹ 6,400. In case of landholding, the size of landholding should not exceed one acre (irrigated land) or 2.5 acre (unirrigated land).

(c) 2/3 of banks DRI advances must be routed through its rural and semi-urban branches.

(d) The scheme does not prescribe any margin money.

(e) Physically handicapped persons are entitled to assistance to the extent of ₹ 5,000 for acquiring aids and equipment.

(f) No security required for loans advanced.

(g) Period of repayment of loans is maximum of five years.

(h) At least 40 per cent of banks DRI advances should go to SC/ST.

16.6 INTEGRATED RURAL DEVELOPMENT PROGRAMME (IRDP)/ ANTI-POVERTY PROGRAMME

Integrated Rural Development Scheme was introduced in 1978-79 due to the failure of the then existing programs to successfully achieve their objectives. A number of then existing programs such as National Rural Employment programme (NREP), Training of Rural Youth for Self Employment (TRYSEM) etc. were submerged under this programme.

Key features:

- At the ground level, program is administered by the District Rural Development Agencies (DRDAs). Beneficiaries are entitled to capital subsidy, loan assistance etc. DRDA is the connecting link between the beneficiaries and the implementing banks.
- It covers the small and marginal farmers, agricultural labourers, artisans, landless agricultural workers, schedule castes and schedule tribes and those living below Poverty line (BPL).
- The program focussed on increasing agricultural productivity and production; diversification of agriculture through poultry, dairy, fishery, sericulture etc.; providing infrastructural facilities such as processing, storage, marketing etc.; creation of assets etc.
- Program covers primary activities such as agricultural, animal husbandry, fisheries etc., secondary activity such as handlooms, handicrafts, pottery, khadi industries etc. and tertiary activities such as tailoring, transport etc.

16.7 WOMEN ENTREPRENEURS

Women entrepreneurs face a number of difficulties due to their limited access to credit, educational and other opportunities besides gender based discrimination. In recognition of the specific problems faced by them, the government of India has from time to time implemented a number of schemes or programmes via commercial banks to facilitate growth of women entrepreneurship. Reserve Bank has played a key role in coming up with new schemes aimed at facilitating better credit availability for women entrepreneurs. As the scope of the topic is very wide, only few projects, schemes implemented by banks are discussed hereunder to give an idea as to the role of banks in developing women entrepreneurship. There are a number of financial institutions which support women in starting new enterprises. These include;

Rashtriya Mahila Kosh: National Credit Fund for women or the Rashtriya Mahila Kosh (RMK) was set up in 1993 by Ministry of Human Resouce Development to provide credit to women in cases where the banking sector is unable to reach.

Stree Shakti Package by State Bank of India: This scheme is run by State Bank of India and is aimed at helping women entrepreneurs. Enterprises where more than 50% of share capital is owned by women are entitled to avail benefit under this scheme. No security is required for loans up to 5 lakhs. Also, if the loan exceeds Rs. 2 lakh, the interest rate is lowered by 0.5%. The scheme offers concession in margin, the rate of which varies for retail traders, business

enterprises, professionals and self-employed women and Small Scale industries. State Bank of Mysore has also come up with Stree Shakti Package for Women Entrepreneurs. Entrepreneurs who have undergone EDP conducted by State level Agencies or programmes cosponsored/sponsored by Bank are eligible for financial help. State Bank of Mysore has launched Annapurna Scheme for Financing Women for Establishing Food Catering Units. Punjab National Bank has various schemes for women and easy credit is available for financing crèches, meeting working capital credit requirement etc. Punjab and Sind Bank has launched the P&S Bank Udyogini Scheme. Under the scheme, women are entitled to loan facility on liberal terms and credit is available for direct agricultural activities, tiny SSI Sector, business enterprises, retail traders etc. similarly, State Bank of Travancore has launched the Mahila Vikas Scheme to provide term loan/ working capital to women entrepreneurs. The said units should have a minimum of 51% financial interest being owned by women and at least 50% of the employment generated must be given to women. We also have, Andhra Bank running the ALEAP and CGTSI- Mutual Credit Guarantee Scheme for women under which credit facility in Micro and Small Enterprises sector both for manufacturing and service activity is available.

National Agricultural Bank of Rural Development (NABARD): NABARD has taken various initiatives for development of rural women. These include –

(a) Assistance for Marketing of Non Farm Products (MAHIMA) - Under this scheme, agencies marketing products manufactured by rural poor women is supported.
(b) Development of Women through Area Programmes (DEWTA) - This scheme has been successfully carried out in Andhra Pradesh, Orissa and Uttar Pradesh.
(c) Women Development Cells in Banks: This scheme was introduced in 1995 and under it grants were provided to Regional Rural banks and Co-operative Banks for setting up Women Development Cells (WDCs).
(d) Subsidy Programme: Credit Linked Capital Subsidy Scheme (CLCSS) – Under CLCSS for Technology Upgradation of Micro and Small Enterprises, subsidy is provided. NABARD is a nodal agency for routing this subsidy through Cooperative Banks and Regional Rural Banks.

Small Industries Development Bank of India (SIDBI) – SIDBI has launched a Marketing Fund for Women (MFW) under which assistance is available to women entrepreneurs and organizations marketing products manufactured by women.

Swarna Jayanti Shahari Rozgar Yojana (SJSRY) - SJSRY provides for Urban Women Self-Help programme (UWSP). Under the program assistance is provided to urban poor women

for setting up self employment ventures. Revolving funds are also made available to Self-Help Groups (SHGs) and Thrift & Credit Societies (T&CSs) formed by urban poor women. For availing subsidy under the scheme, the USWP group should at least have 5 urban poor women. The group is entitled to a subsidy of ₹ 3,00,000/- or 35% of the cost of project or ₹ 60,000/- per Member of the Group, whichever is less. In case the UWSP group establishes itself as a SHG / T&CS, the SHG / T&CS is entitled to a lump sum grant of ₹ 25,000/- as Revolving Fund at the rate of ₹ 2000/- maximum per member. SHG / T&CS under UWSP should function for at least one year before being entitled to the revolving fund. We have a similar scheme being run for rural poor women. India is also planning to start its first bank exclusively for women to support women Self-Help Groups.

16.8 SMALL SCALE INDUSTRIES

Small scale industries (SSIs) play a very important role in the development of a country's economy via employment generation, foreign exchange earning etc. However spirit of entrepreneurs can be dampened due to unavailability of credit and inadequate support structure. Hence, the government (Ministry of Small Scale Industries) via its banking machinery comes up with a number of incentives for the SSIs. One of the key policies aimed at meeting the credit requirements of SSIs is by earmarking SSIs as a priority sector for bank lending. Reserve Bank has also come up with a number of guidelines to ensure equitable distribution of funds in various sectors of SSIs. As per the Reserve Bank directions, 40% of all funds marked for SSI sector has to be made available to SSIs whose investment in plant and machinery does not exceed ₹ 5 lakhs, 20% has to be made available to SSI Units which have an investment between ₹ 5 lakhs to ₹ 25 lakhs in their plant and machinery and remaining 40% of funds can be given by Banks to other SSI units. Besides this, Reserve Bank has been continuously propagating better allocation of funds to SSIs, increasing their credit share. Other efforts by banks to increase credit availability to SSIs include opening of specialized SSI branches, increase in composite loan limit, opening of specialised SSI branches and various other specialized schemes aimed at providing easy access to credit for SSIs. Few of the main organizations/bodies entrusted with development of SSIs are discussed hereunder:

Small Industry Development Organization (SIDO) - SIDO was established in 1954 for supporting the Ministry of Small Scale Industries in formulating, coordinating and implementing the policies and schemes for development and promotion of small scale industries. It manages a number of autonomous bodies such as Small Industries Service

Institutes, Regional Testing Center, Tool Design Institutes, Product-cum-Process Development Centres and Training Institutes.

National Small Industries Corporation (NSIC) – NSIC was set up in 1955 and plays a key role in development of SSIs. It has floated a number of loan schemes for helping entrepreneurs acquire land, building, machinery, equipment etc. A number of schemes making available working capital, raw material, equipments and machinery to SSIs are being implemented by NSIC. It also supports SSIs in marketing of their products and has set- up a NSIC-STP Complex under Software Technology Parks of India (STPI) where SSIs are promoted to undertake software development.

State Directorate of Industries (SDIS) – This body is responsible for registering small scale industries and providing them financial help.

State Industrial Development Corporation (SIDCS) – These are state level bodies entrusted with the task of developing industry in State by providing a number of services to new industrial enterprises. These include providing finance to small, medium and large enterprises and motivating entrepreneurs to undertake industrial ventures.

District Industries Centres (DICS) – These Centres are entrusted with the task of providing support to SSIs at the district level.

Khadi and Village industries Commission (KVIC) – KVIC is entrusted with development of Khadi and other village industries.

Small Industries Development Bank of India (SIDBI) – SIDBI was established in 1990 and is entrusted with the responsibility of providing financial assistance to SSIs either directly or indirectly. Through the direct mode of assistance, loans are made available to SSIs and by indirect mode of assistance, capital is made available through existing state level institutions.

16.9 AGRICULTURAL FINANCE

Agricultural finance refers to the study of financial aspects of farming business. As regards India, agricultural finance is very important because Indian economy is primarily agriculture based. Agricultural finance aims at looking into ways by which farming business can be developed and better use of available resources can be made. Aim of agricultural finance is to increase agricultural productivity by making available finance for availing new technology, better seeds and fertilizers, irrigation facilities etc. Growth of agricultural sector has a direct impact on the rural standard of living and promotes equitable distribution of wealth in the society. Banks today play a very vital role in making available agricultural finance and the thrust of governmental policies is to replace credit facility provided by money

lenders with banks as private moneylenders often abuse the vulnerable position of farmers. To achieve this purpose, a number of commercial banks, co-operatives and regional rural banks provide credit facilities to farmers often at a concessional rate depending upon governmental policy as implemented by Reserve Bank of India from time to time.

Need for agricultural finance is usually for a short term. Most farmers need cash for crop cultivation and credit crunch ceases to exist on successful crop harvest. Such crop-loans, intended to finance agricultural inputs are required for few months to a year depending upon the crop grown. At times, requirement of agricultural finance might also come up for a longer period of time. This can be either for a medium term such as 2-5 years or for a longer period of 5-20 years in case finance is availed for purchase of land, tractors, tube-wells etc. Other than these requirements, money can also be needed for marketing agricultural produce. Loans advanced for any purpose other than agricultural purposes are known as consumption loans and are aimed at helping the farmers to meet some personal or other emergencies. Usually, the scope of such loans is restricted to a narrow category of beneficiaries under some government scheme. Agricultural finance covers both financial requirements for core agricultural practices and other allied activities such as dairy farming, poultry farming, pisiculture etc. Usually loans advanced for allied activities take some time for repayment. However, the benefits of agricultural finance are restricted as Indian farmers suffer from a number of handicaps. These include small and fragmented landholdings, illiteracy, poor management practices etc.

16.10 EXPORT FINANCE

Promotion of export is one of the key functions of Reserve Bank. Exports are important for the economic development of a country and help in maintaining adequate resources of foreign exchange. To facilitate exports, a number of facilities are provided to exporters including credit facility. Export credit is provided both for meeting pre-shipment (assistance provided to exporters prior to shipment of goods for meeting working capital requirements, cost of packaging, processing, transportation, warehousing etc.) and post-shipment (assistance provided to exporters after shipment of goods) requirements and is available both in rupees and in foreign currencies. The Reserve Bank has come up with a number of directives in this regard with the first Export Financing scheme being introduced in 1967. Few of the key features of the present Export Credit scheme contained in different circulars issued by Reserve Bank from time to time are discussed below.

- Pre-shipment credit requirement covers exporter's financial needs for purchasing, processing, manufacturing and packaging of goods prior to shipment. This is usually provided on the basis of a letter of credit or upon proof of an export order.
- The period for which advance is provided varies from case to case and banks take into consideration relevant factors such as the time required for procuring, manufacturing or processing and shipping the goods.
- Banks can also provide Pre-Shipment Credit 'Running Account' Facility for any commodity. This 'Running Account' facility is keeping in mind special circumstances when the exporter might have to keep the goods ready for shipment even prior to receiving the order. In such cases, banks do not insist on Letter of Credit or export order. Banks can restrict this service to exporters with good track record or to exporters from Special Economic Zones, Export Processing Zones etc. However, even in such cases, letters of credit or export order should be made available to the bank as soon as possible.
- Export credit can also be made available by banks against proceeds of cheques, drafts etc. upon fulfilment of other conditions such as general trade practices and approved methods.
- Banks can also provide export credit to exporters who do not have the export order or the letter of credit in their own name in case the goods are exported thorough some export agency or trade corporation.
- Export packing credit can be provided by banks and such credit can be shared between the Export Order Holder (EOH) and sub-supplier of raw materials and components.
- Export credit can be provided to exporters of services covered under General Agreement on Trade in Services in case the payment of such services is received in free foreign exchange.
- Export credit can also be provided to Processors/Exporters of Agri-Export Zones which have been set up by government to promote agricultural exports. Credit facility can be provided for procuring and supplying agricultural inputs.
- Credit can also be provided by banks post shipment which will extend from the date of providing credit after shipment of goods/rendering of services to the date of realisation of export proceeds. The present prescribed period of realization is 12 months from date of shipment.

- Post-Shipment credit can be in the form of – (i) Export bills purchased/discounted/negotiated; (ii) Advances against bills for collection; (iii) Advances against duty drawback receivable from Government.
- Post- Shipment credit is to be liquidated by banks from proceeds of export bills received. Loan can also be repaid out of balances in Exchange Earners Foreign Currency Account (EEFC A/C).
- Banks providing export credit are protected against non-payment of post-shipment credit by the Export Credit Guarantee Corporation of India Ltd.
- Banks can provide concessive rupee export credit against deemed exports. However, this should be for projects aided/ financed by bilateral or multilateral agencies such as World Bank and IDA. The list of such agencies will be notified by Department of Economic Affairs, Ministry of Finance under the Chapter 'Deemed Exports' in Foreign Trade Policy.
- While Reserve Bank prescribes the ceiling rate for interest on rupee export credit, banks are free to prescribe the actual rate within the ceiling rate. Such rate has to be fixed on the basis of Benchmark Prime lending Rate (BPLRs).
- Banks are free to prescribe the rates for ECNOS (Export Credit not Otherwise Specified in the Interest Rate Structure.)
- Credit is also available to exporters in foreign currency. However, this facility is allowed only in case of cash exports.
- In case of post-shipment export credit in foreign currency, banks can use the foreign exchange resources in Exchange Earners Foreign Currency Accounts (EEFC), Resident Foreign Currency Accounts (RFC) and Foreign Currency (Non-Resident) Accounts to discount bills.
- Banks can also provide for Bankers Acceptance Facility for rediscounting export bills without any margin.
- Banks are to open Export Counsel Offices to help exporters. Banks are to implement the Gold Card Scheme under which additional benefits are made available to exporters on the basis of their previous performance. As per the scheme, all creditworthy exporters are entitled to Gold Card by banks. This includes exporters in small and medium sectors. Gold Card holders are given better terms of credit including rate of interest in comparison to the rates which are given to other exporters.

16.11 HOW THE BANKER PROFITABLY USES THE FUNDS?

The funds obtained by banks are used for a number of purposes. The aim of banks is to use the funds in such a manner that a bank is able to increase its earnings. Banks operate on profit motive like other commercial entities and hence they seek to get maximum benefit from the resources at their disposal. The primary purposes for which banks use their funds are the following:

(a) Banks provide loans to different individuals/entities. Usually the rate at which banks provide loans is higher than the rate at which they give interest to deposit holders. This difference in rate of interest accounts for the profit of the banks. While providing loan, banks are cautious of the creditworthiness of the borrower so as to minimize its liabilities in the form of defaulters. To gauge the financial health of a borrower, banks look into a number of factors before advancing money. This includes credit history of the borrower, purpose for which loan is being sought, sources of income of borrower etc. Banks also, often insist upon some security before advancing loans to cut down their risks. Lending by banks can exist in different forms such as home loans, educational loans, personal loans, overdraft facilities and credit card facilities.

(b) Banks also use their funds for investing in different securities and making profits thereon. Usually banks diversify their portfolios and invest in a mix of stocks ranging from those giving high returns to stable securities with guaranteed returns. This planning of diversified investment would be done by the experts, so as to negate the market risks associated with them.

(c) Banks also use their funds for trading in currencies and making profits upon the price difference.

16.12. CALL LOANS AND LOANS REPAYABLE AT SHORT NOTICE

Calls loans are a type of loans which are repayable on demand. There is no fixed schedule of loan repayment and the loan can be ‘called’ at any moment. This makes the position of borrower vulnerable because the lender can ask for repayment according to his convenience. However, the borrower might stand to benefit due to flexible repayment schedule. The rate of interest upon a call loan is known as the call loan rate and is usually calculated on a daily basis on the outstanding balance. Call loans can also be known as demand loans in which the borrower has to repay the entire loan amount on demand. These loans do not have a maturity period or a fixed repayment schedule. Demand loan facility is

made available by banks only when the borrower has a stable credit history. Often banks enter into demand loan agreements with companies having sound financial condition.

16.13 OVERDRAFTS

Overdraft refers to over-drawing of the monetary limit of an account by an account holder. Usually, we can withdraw, only so much money from our account as is present in our account. In case of overdraft, the account holder takes out more money than that available in his account. Banks often provide overdraft facility for a charge and put a higher rate of interest on the amount withdrawn. Such types of overdraft are known as pre-arranged overdraft. Pre-arranged overdrafts can also subsequently become unarranged if the account holder crosses the maximum monetary limit fixed by the bank in case of arranged overdrafts.

Account holders often prefer arranged overdraft facility as it offers a number of advantages. Firstly, the account holder is assured of credit facility in case of shortage of funds. This ensures that important bills, cheques etc. will not suffer due to inadequate funds. Secondly, arranged overdraft facility is cheaper than unarranged overdraft facility as the rate of interest charged in case of unarranged overdraft facility is higher. So in cases where the account holder is aware of nature of his financial transactions, the account holder can avail of such facility. Thirdly, account holder can in the form of overdraft facility avail of the loan facility of banks without having to go through the stringent checks applicable for standard loan applications. However, overdraft facility cannot replace the benefits of long term loans due to the high rate of interest charged. Overdraft facility can prove to be costly in case it is not repaid quickly. So account holders have to be conscious of pending overdrafts.

16.14 LEGAL CONTROLS OVER BANK’S DEPLOYMENT OF FUNDS

There are a number of controls over banks use of funds. This is because banks are entrusted with public deposits and hence it is one of the chief functions of Reserve Bank to keep an eye over as to how banks use the funds available to them via deposits or some other means. The Indian banking scenario is a heavily regulated one with Reserve Bank putting in a number of checks to prevent banks from misusing public funds. Following are some of the key checks in this regard.

- There are two mandatory annual audits of banks and banks in general operate under the strict supervision of Reserve Bank.
- All banks have to comply with Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements. CRR provided under Section 42 (1) of Reserve Bank of India Act 1934 is the amount of funds that all Scheduled Commercial Banks (SCBs)

have to maintain with Reserve Bank with reference to their total net Demand and Time Liabilities (DTL) to ensure liquidity. To calculate DTL, all three i.e., demand liabilities, time liabilities and Other Demand and Time Liabilities are taken into account. Demand liabilities of banks are those liabilities which are payable on demand. All other liabilities are time liabilities. Demand liabilities include savings bank deposits, current deposits, money at call and short notices, margins held against letters of credit etc. Time liabilities include fixed deposits, cash certificates, gold deposits, recurring and cumulative deposits etc. Other Demand and Time Liabilities (ODTL) include unpaid dividends, interest accrued on deposits, suspense account balance and net credit balance. Liabilities under DTL do not include paid up capital, credit balance in profit and loss account, reserves, amounts received from Court Receiver, District Rural Development Agency (DRDA) subsidy of Rs. 10,000/-, subsidy of NABARD under Investment Subsidy Scheme for Construction/Renovation/Expansion of Rural Godowns, loans taken from Reserve Bank etc. Current CRR is 4.75%.

All SCBs have to maintain minimum CRR balance of up to 70 per cent of daily average required reserves for a reporting fortnight on all days of the fortnight. Also, SCBs have to submit a provisional Return within 7 days from the expiry of the relevant fortnight. If there is default in maintenance of CRR requirements on a daily basis, SCBs are subject to penal interest for that day.

Banks have to maintain a minimum portion of their Net Demand and Time Liabilities as liquid assets at the close of business on a daily basis. The ratio of liquid assets to demand and time liabilities are known as SLR as provided under Section 24(2) of Banking Regulation Act 1949. Liquid assets of the banks include Treasury Bills of Government, State Development Loans (SDLs) of State Government, Dated Securities of Government of India etc. In case of default in maintenance of prescribed SLR, banks are to pay penal interest. SCBs have to submit to the Reserve Bank a return showing the amount of SLR held on alternate Fridays during immediate preceding months. This return has to be submitted before 20th of every month.

Both CRR and SLR requirements aim at keeping a substantial part of bank liquid at all times.

- Reserve Bank monitors bank's lending by putting sectoral caps and via Capital Adequacy Ratio. Putting sectoral caps helps in diversification of risk. Under Capital adequacy, each kind of lending is assigned a risk weightage and the risk weightage

determines allocation of capital. Secured instruments carry zero weightage risks while unsecured instruments carry 100 per cent risk weightage. Also banks have to put their own money in every lending, the percentage of which to the total risk weighted asset of the bank is determined by Reserve Bank.

- Central Government Deposit Insurance Scheme provides that all deposits up to a limit of Rs. 1 lakh are insured by Government. This scheme is implemented by the Deposit Insurance and Credit Guarantee Corporation (DICGC). DICGC insures all commercial banks including braches of foreign banks operating in India.

16.15 SUMMARY

Banks accept deposits from people and also advance loans. This is one of the primary functions of banks. Loan (in context to money) refers to borrowing of some money by one person from another. The said amount borrowed is known as the loan amount. Advance is a 'credit facility' made available by bank usually for short term (one-two years). Repayment of the loans and advances lent by banks is a key issue for banks and banks look into a number of factors before advancing these loans and advances. Regulation on loans and advances is contained in the Banking Regulation Act 1949 (primarily Section 19, 20) and the Reserve Bank Circulars on loans and advances.

This key function of bank in making available loans and advances has a very vital impact upon societal and economic development in the form of giving special attention to needy sectors, DRI Scheme etc. Differential Rate of interest Scheme (DRI) was introduced in India in 1972 on the recommendations of Dr. B. K. Hazare chaired RBI Committee and is implemented by all Indian Scheduled Commercial banks. Under the DRI scheme, individuals belonging to weaker sections of the society are given loans at concessional rate of 4 per cent per annum without insisting upon security. A number of concessions and lucrative schemes are also floated for encouraging women entrepreneurs and small scale industries with a number of key sectors facing credit crunch being marked as priority sectors for lending. Reserve Bank has also worked for making agricultural finance and export finance easily available. There are a number of controls over bank's use of funds. This is because banks are entrusted with public deposits and hence it is one of the chief functions of Reserve Bank to keep an eye over as to how banks use the funds available to them via deposits or some other means. The Indian banking scenario is a heavily regulated one with Reserve Bank putting in a number of checks to prevent banks from misusing public funds.

16.16 KEY WORDS

1. Credit Facility
2. Loans
3. Advance
4. Restrictions on Advances
5. Regulation on Loans
6. Priority Sector Advances
7. Direct Finance-Indirect Finance
8. Self Employment Scheme
9. Differential Rate of Interest Scheme
10. Integrated Rural Development Programme
11. Women Entrepreneurs
12. Small Scale Industries
13. Agricultural Finance
14. Export Finance
15. Call Loans
16. Loans Repayable at Short Notice
17. Overdrafts

16.17 SELF ASSESSMENT QUESTIONS

1. What do you mean by loans and advances? Discuss the different types of loans.

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2. Briefly mention the regulations on loans and advances as contained in the Banking Regulation Act 1949 and the Reserve Bank Circulars on loans and advances.

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3. What are priority sector advances? What is its role in framing socio-economic policies?

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   ....

4. Critically evaluate the eligibility criteria for availing Differential Rate of interest Scheme.

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5. How do banks facilitate women entrepreneurs and small scale industries?

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6. What is the role of bank in making available the agricultural finance and export finance?

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7. Discuss call loans and overdraft facility.

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8. Elaborate the legal controls over banks deployment of funds.

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UNIT-17: SECURITIES FOR BANKERS LOAN

Structure:

17.0 Objectives
17.1 Introduction
17.2 Guarantees
17.3 Pledge
17.4 Lien
17.5 Mortgage
17.6 Charge
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17.9 Land and buildings
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17.18 Key words
17.19 Self Assessment Questions
17.20 References

17.0 OBJECTIVES

- To understand the various forms of securities that banks insist upon while advancing loans.
- To know the different secondary facilities provided by banks such as bank guarantee, letter of credit, factoring and bill discounting.

17.1 INTRODUCTION

One of the key functions of banks is to advance loans and charge an interest on it. This interest is the earning of the bank. However, in a number of cases, there might be default of loan repayment and in such cases the loans advanced become a non-performing asset of the banks. In such circumstances, rather than becoming a source of income for the banks, loans become liabilities on part of the banks. This makes it necessary that banks should adopt a cautious attitude before advancing loans and the creditworthiness of the borrower should be firmly established. Besides looking into the past credit history of the borrower, banks also insist upon security to ensure payment of the bank. Depending upon whether security has been taken for a loan, loans can be either secured or unsecured.

Secured loans are advanced against some security by the borrower, which may include personal security or collateral security. In case of personal security, borrower himself guarantees repayment of loan. In case of collateral security, loans are secured by some property. Property can be both movable and immovable. Movable property would include Insurance bonds, machinery, fixed deposit bonds, jewellery (pledge) etc. Immovable property includes land, buildings etc. (mortgage). Loans can also be secured via hypothecation wherein the movable property remains in the possession of the borrower but the bank has the right to take possession of the same on default. This form of security is usually employed to secure loans advanced for purchase of machinery, vehicles etc. Loans advanced by banks without insistence of any security upon mutual trust between the banker and the borrower are known as unsecured loans.

17.2 GUARANTEES

Guarantees are a form of security for loans advanced by banks and are provided under the Indian Contract Act 1872. Section 126 defines a contract of guarantee as a contract to perform the promise or discharge the liability of a third person in case of default. The person who undertakes this liability is known as the ‘surety’ and the person in respect of whose default, the guarantee is given is known as the ‘principal debtor’. Bank i.e., the person to

whom the guarantee is given is called the ‘creditor’. For a contract of guarantee to be valid, it can either be oral or written.

One of the essentials of a valid contract is presence of consideration. For a contract of guarantee, consideration need not always be monetary consideration. Anything done or promised to be done for the benefit of the debtor can be sufficient consideration for the surety. The guarantor or the surety bears the same liability as that of the principal debtor. Section 128 provides that the Surety’s liability is co-extensive with that of the principal debtor. However, the surety is free to restrict his liability by a contract between the parties. Illustration to Section 128 provides that in case A guarantees to B the payment of a bill of exchange by C, the acceptor and the bill is dishonoured by C, A is liable not only for the amount of the bill but also for any interest and charge which may have become due on it.

The surety can guarantee any specific transaction of the debtor or can also guarantee a series of transaction. Guarantees extending to a series of transactions are known as ‘continuing guarantee’ and as the name suggests such guarantees continue until revocation or till some specified time period, event, extent etc. Revocation of continuing guarantee has to be done upon notice to the creditor under Section 130. In the absence of any contract to the contrary, death of the surety results in automatic revocation of a contract of continuing guarantee (Section 132).

In case there is more than one guarantor, the guarantors cannot enter into a contract with each other to make one of them liable only upon the default of the other, if the debtor i.e., the bank is not a party to such contract. It is immaterial if the bank is aware of any such contract having been entered into. Section 132 provides an illustration in this regard that if A and B make a joint and several promissory note to C and A makes it as surety for B, and C knows this at the time when the note is made, even then C can bring a suit against A upon the note. A surety is discharged from his liabilities under a contract of guarantee in case the terms of contract are varied without his consent. This is because, variance in the terms of contract changes the nature of the liabilities the surety had initially agreed to undertake and the surety cannot be made liable for such obligations to which he has not given his consent in the first place. Section 133 in this regards by way of illustration provides that if A becomes surety to C for B's conduct as a manager in C's bank and afterwards B and C contract, without A's consent, that B's salary shall be raised, and that he shall become liable for one- fourth of the losses on overdrafts and B allows a customer to overdraw making the bank lose a sum of money, A is discharged from his suretyship due to variance made without his consent.

Under Section 134, surety is discharged from his liability when the principal debtor is released from his liability. The principal debtor can be released from his liability either upon successful discharge of the contract or due to happening of some event, incident, act or omission, the legal effect of which is discharge of the principal debtor. Surety is also discharged under Section 135 in case the creditor compounds with, gives time to or agrees not to sue the principal debtor. However, such a contract has to be made with the principal debtor and not a third party. If the contract to allow time to the principal debtor is made by the creditor with a third person, surety is not discharged of his liability (Section 136). In addition, the surety is also discharged of his liability if the creditor does any act or omission which impairs his eventual remedy (Section 139).

Surety is not discharged from his liability if the creditor merely forbears from suing the principal debtor or enforcing any remedy against him. Section 137 by way of illustration provides that if B owes to C a debt guaranteed by A and the debt becomes payable but C does not sue B for a year after the debt becomes payable, A is not discharged from his suretyship. Surety is also not discharged from his liability in case of release of one co-surety (Section 138). In case the surety performs the contract for which he is liable, the surety acquires all the rights which the creditor had against the principal debtor (Section 140). The surety then is entitled to every security which the creditor had against the principal debtor at the time the contract of suretyship was entered into. It is immaterial whether the surety knows of the existence of such security or not. If the creditor without the consent of the surety loses the security or some part of the security, surety is discharged to the extent of the value of the security. A contract of guarantee to be valid should also not have been obtained by misrepresentation (Section 142) or by concealment (Section 143).

The surety has the option of insisting upon a co-surety. Thus, if a guarantor agrees to act as surety only if another person joins as a co-surety, the contract of guarantee is not valid if the other person does not join (Section 144). Section 145 provides that in every contract of guarantee, there is an implied promise by the principal debtor to indemnify the surety and the surety has the right to recover from the principal debtor any sum which he might have paid under the guarantee. The liabilities of the co-sureties, in case there are two or more persons is equal. The co-sureties in the absence of any contract to the contrary are liable to pay an equal share of the whole debt or equally in the part which remains unpaid by the principal debtor. Thus if A, B and C are sureties to D for the sum of 3,000 rupees lent to E and E makes default in payment, then, A, B and C are liable to pay 1,000 rupees each. Even if the co-

sureties are bound in different sums, they are liable to pay equally as far as the limit of their respective obligations permit (Section 147).

In *Ansal Engg. Projects* v. *Tehri Hydro Dev. Corporation* [1996 (Suppl) ISJ (Banking) 523, suit was filed by Petitioner seeking injunction to restrain Respondent from invoking the bank guarantee pending determination of the amount due and payable by the Petitioner. The Court held that bank guarantee is an independent and distinct contract between the bank and the beneficiary. Bank guarantee is not qualified by the underlying transaction and validity of the primary contract. Unconditional and irrevocable bank guarantee help in the free flow of trade and commerce and are not dependent upon results of disputes between the beneficiary and the contractor. The beneficiary of a bank guarantee can invoke the bank guarantee and encash the amount specified in the guarantee. Courts do not have power to interfere with enforcement of bank guarantee except in cases of fraud or special equity. Again, in *National Thermal Power Corporation Ltd.* v. *Flowmore Pvt. Ltd.* [(1995) 84 Comp Cas 97; II (1995) BC 221], Court held that courts should not interfere with a performance bond or bank guarantee unless there is fraud of the beneficiary. Bank need not bother about any *inter se* dispute between the beneficiary and the person at whose instance the bank guarantee was issued. Only because the guarantee was not invoked, while the arbitration proceedings were pending, does not lead to the conclusion that the bank guarantee cannot be invoked while arbitration is pending.

17.3 PLEDGE

Pledge is another mode by which banks secure their loans. Section 172 of Indian Contract Act 1872 defines pledge as the bailment of goods as a security for payment of a debt or performance of a promise. Bailment has been defined under Section 148 of the Contract Act as the delivery of goods by one person to another for some purpose upon a contract. Once the purpose is accomplished, the goods are to be returned or disposed off according to the directions of the person delivering them. The bailor in case of a pledge is known as the pawnor and the bailee i.e., the bank is known as the pawnee.

Pledge is a very convenient mode of securing loans and often government promissory notes, railway receipts, insurance policies, bonds, shares etc. are pledged as way of security. Pledge of shares is a very prevalent financial transaction opted to by companies and other individuals to meet their short term credit requirements. Banks also are willing to accept shares as pledge due to its easy liquidity, making it possible for banks to easily recover their loan amount in case of default by the borrower. Pledging of shares is also preferred due to its

easy delivery method. Section 12 of Depositories Act 1996 provides that shares can be pledged in Demat form. The beneficial owner can create a pledge over any security owned by him with the previous approval of the depository. The depository has to be informed of the pledge created so that the depository can accordingly make necessary entries in its records i.e., the depository registers the pledge as the beneficial owner. Regulation 58 of the SEBI (Depositories and Participants) Regulations, 1996 also provides for a similar procedure. However, pledge of financial instruments, other than those which provide a fixed rate of return, is also risky as the value of these financial instruments can vary from time to time. Thus, shares of a company which may seem to be a valuable asset to be accepted as security for advancing a loan may lose its relevancy in case the price of shares falls down.

Essential conditions of a valid pledge are

(a) The subject matter of the contract i.e., the goods must be a specific movable property. 'Goods' has been defined under Sale of Goods Act 1930 as "every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale".

(b) The goods pledged have to be delivered by the pawnor to the pawnee. Such delivery can be either actual or constructive. Actual delivery is one where the goods are physically transferred by the pawnor to the pawnee. In case of constructive delivery, there is some symbolic act, the result of which is to put the pawnee in possession of the goods, say, by handling of keys of the warehouse or delivery of shares through DEMAT form etc.

(c) The delivery should be in return of a loan or a promise and in pursuance of a contract. The delivery is a security for a debt or performance of an obligation. It is not necessary that delivery should be done at the time of payment of loan.

(d) The delivery of goods must be with an intention to return the goods. The pawnee should have the intention of returning the goods on repayment of the debt or performance of the obligation. The delivery is not permanent in nature.

Rights of the Pawnee:

Right to Retain Goods: Section 173 provides that a pawnee has the right to retain the goods pledged, not only for the payment of a debt or performance of a promise but also for the interest of the debt and for recovering all necessary expenses incurred by the pawnee for preservation of goods pledged. Section 174 provides that the pawnor shall

not retain the goods pledged for debt or promise other than the debt or promise for which they have been pledged.

Right to Recover Extra-Ordinary Expenses: The pawnee also has the right to recover extra-ordinary expenses incurred by him for the preservation of the goods pledged under Section 175.

Rights of Sale: Under Section 176, in case of default by the pawnor, pawnee has the right to bring a suit against the pawnor or retain the pawn as collateral. Even if there is an express authority given by pawnor to pawnee to sell the sell the goods, the pawnee can still institute a suit against the pawnor. The pawnee can also sell the goods pledged after giving reasonable notice to the pawnor. Requirement of giving a proper and reasonable notice is a mandatory requirement and non-compliance of this requirement invalidates the sale. Even if there is a contract to the contrary, this requirement cannot be done away with. A pawnor cannot force the pawnee to exercise the right of sale. If after selling the goods the value of the goods is more than the sum due to the pawnee under the debt or promise, pawnor is entitled to get the difference in value. However, if the sale proceed is less than the debt amount, pawnee is entitled to receive the difference.

Right to retain accretions: The pawnee has the right to retain any direct accretion to the property pledged. The pawnee cannot claim consequential or indirect accretions.

Rights of the Pawnor:

Pawnor has the right to redeem the goods at any time before actual sale of the goods under Section 177. The pawnor, however, has to pay any additional expense incurred by the pawnee due to default by the pawnor, in case of redemption post default.

Generally goods can only be pledged by the owner of the goods but the Indian Contract Act recognises certain situations where in the interest of commercial trade, goods can be pledged by non-owners of the goods. Section 178 provides for pledging of goods by a mercantile agent. A mercantile agent in possession of the goods with the consent of the owner can pledge such goods and any such pledge made in the ordinary course of business will be valid. Moreover, the pawnee should act in good faith and should not be aware of the fact that the pawnor had no authority to pledge. Section 178 provides another instance wherein goods can be pledged by one other than the owner. In case a person obtains goods under a voidable contract and the contract had not been avoided at the time of pledge, then such person can create a valid pledge. Section 179 provides for pledge by a person who has limited interest in the goods. In such cases, the pledge is valid to the extent of interest of the pawnor.

17.4 LIEN

Lien is the right of the bailee to retain possession of goods or any other security held by him until the repayment of his debt. The right of lien gives the creditor to keep goods or any security in his possession until the debt is paid. This is an important mode opted by banks for securing their advances. In India, there are no legal requirements for creating a right of lien. Section 171 of the Indian Contract Act 1872 provides for implied contracts of lien provided there is no contract to the contrary. If there is a contract expressly taking away the right of lien, the banker cannot subsequently retain possession of the goods or security even in case of default. Also, it is necessary that the property reaches the hands of the banker in the ordinary course of business and the possession of the property is lawful.

The right of lien can be general or specific. General right of lien exists over all property in possession of the bailee. In case of particular lien only that good/property can be retained over which some charges remain unpaid. Section 171 of the Indian Contract Act 1872 gives the banker a general right of lien. It provides that bankers, factors, wharfingers, attorneys and policy brokers can in the absence of a contract to the contrary, retain as security for a general balance of account, any goods bailed to them. It further provides that other than the persons specified, no other person has the right to retain goods bailed to them as a security unless there is an express contract to that effect. The right of lien is also available to the finder of goods for his necessary expenses incurred in preservation of the goods, an agent or an unpaid seller. An agent has a right of lien on his principal's goods, papers and other property until the amount due to him is paid. An unpaid seller too can exercise right of lien even though the property in the goods pass to the buyer in the capacity of an agent or bailee for the buyer.

17.5 MORTGAGE

Mortgage is another mode adopted by banks to secure their loans. In case of mortgage, an interest in a specific immovable property is transferred for securing the money advanced or any other obligation of pecuniary nature. The person who transfers his interest in the property is known as the mortgagor and the transferee (in this case, the bank) is known as the mortgagee. The principal money and interest, the payment of which is secured via the mortgage is known as the mortgage-money and the instrument by which the transfer takes place is known as the mortgage deed. Different kinds of mortgage are recognized under the Transfer of Property Act. These are:

Simple Mortgage - In case of simple mortgage, there is no delivery of possession of the mortgaged property. Further, the liability of the mortgagor is personal i.e., the mortgagor binds himself personally to pay the money and if he fails to do so, the mortgagee has the right to sell the mortgaged property.

Mortgage by conditional sale - In this type of mortgage, the mortgagor ostensibly sells the mortgaged property with a condition that in case of default of payment, the said sale will become absolute. However, if the payment is made, the sale becomes void. Alternatively, the deed may have a condition that in case of payment being made, buyer will transfer the property to the seller.

Usufructuary Mortgage - In case of this type of mortgage, mortgagor delivers possession of the mortgaged property to the mortgagee and the mortgagee is authorised to retain possession of the said property until the mortgage money is paid. The mortgagee has the right to receive rents and profits accruing from the property in lieu of interest or in payment of the mortgage money or partly in lieu of interest or partly in payment of mortgage money.

English mortgage - In this type of mortgage, the mortgagor binds himself to repay the mortgage money on a certain date. The mortgaged property is absolutely transferred to the mortgagee with a proviso that the mortgagee will re-transfer it to the mortgagor upon payment of the mortgage money.

Mortgage by deposit of title deeds - This type of mortgage is vastly preferred by banks and under it, documents of title to the immovable property is delivered to the mortgagee.

Anomalous Mortgage - All other kinds of mortgage come under it.

The Act gives a number of rights and liabilities to the mortgagor and the mortgagee. The rights and liabilities of the mortgagor are:

(a) Right of mortgagor to redeem(Section 60):

At any time after the principal money has become due, mortgagor has right on payment or tender, at a proper time and place, of the mortgage money, to require the mortgagee

i. To deliver to the mortgagor the mortgage deed and all documents relating to the mortgaged property which are in the possession or power of the mortgagee;
ii. If the mortgagee is in possession of the mortgaged property, to deliver possession thereof to the mortgagor; and
iii. To re-transfer the mortgaged property to the mortgagor or to such third person as the mortgagor may direct,

iv. To execute, and where the mortgage has been effected by a registered instrument to have registered an acknowledgement in writing that any right in derogation of his interest transferred to the mortgage has been extinguished.

(b) Obligation to transfer to third party instead of re-transference to mortgagor (Section 60A):

Where a mortgagor is entitled to redemption, mortgagor may require the mortgagee that instead of retransferring the property, to assign the mortgage debt and transfer the mortgaged property to such third person as the mortgagor may direct the mortgagee. and the mortgagee shall be bound to assign and transfer accordingly.

(c) Rights to inspection and production of documents (Section 60B)

A mortgagor has the right to inspect and make copies or abstracts of or extracts from documents of title relating to the mortgaged property in custody or power of the mortgagee.

(d) Rights to redeem separately or simultaneously (Section 61):

A mortgagor who has executed two or more mortgages in favour of the same mortgagee shall, in the absence of a contract to the contrary, be entitled to redeem any one such mortgage separately or any two or more of such mortgages together.

(e) Right of usufructuary mortgagor to recover possession(Section 62):

In case of usufructuary mortgage, mortgagor has a right to recover possession of property along with the mortgage deed and all documents relating to the mortgaged property in possession or power of the mortgagee.

(f) Accession to mortgaged property (Section 63):

Where mortgage property in possession of mortgagee receives any accession, mortgagor upon redemption, shall be entitled to such accession unless there is a contract to the contrary.

(g) Improvements to mortgaged property (Section 63A):

If mortgaged property is improved, mortgagor, upon redemption, shall, in the absence of a contract to the contrary should be entitled to the improvement.

(h) Renewal of mortgaged lease (Section 64):

If mortgaged property is a lease, and mortgagee obtains a renewal of the lease, mortgagor, upon redemption, shall be entitled to new lease.

(i) Mortgagers power to lease (Section 65):

Mortgagor in lawful possession of the mortgaged property has the power to make leases which will be binding on the mortgagee.

(j) Waste by mortgagor in possession (Section 66):

Mortgagor in possession of mortgaged property will not waste the property by doing any destructive act.

The rights and liabilities of a mortgagee are as under:

(a) Right to foreclosure for sale (Section 67):

In the absence of a contract to the contrary, mortgagee can at any time after the mortgage money becomes due to him, and before a decree has been made for redemption of mortgaged property, or mortgage money has been paid obtain from the Court a decree that mortgagor shall be absolutely debarred of his right to redeem the property or for a decree for sale of property.

(b) Right to sue for mortgage money (Section 68):

Mortgagee has a right to sue for mortgage money if:

i. Mortgagor binds himself to repay the same;
ii. Mortgaged property is wholly or partially destroyed or the security is rendered insufficient within the meaning of section 66, and the mortgagee has given the mortgagor a reasonable opportunity of providing further security enough to render the whole security sufficient, and the mortgagor has failed to do so;
iii. Mortgagee is deprived of the whole or part of his security due to a wrongful act or default of the mortgagor;
iv. Where the mortgagee is entitled to possession of the mortgaged property and the mortgagor fails to deliver the same to him.

(c) Right of power of sale of mortgaged property (Section 69):

Mortgagee has power to sell in case of default of payment of the mortgage money, without intervention of Court, in certain cases. Power of sale can only be exercised after

i. Notice in writing requiring payment of principal money is served on mortgagor and there has been default in payment of the principal money for three months after such service;
ii. Interest under mortgage amounting at least to five hundred rupees, is in arrear and unpaid for three months after becoming due.

(d) Right to appoint a receiver (Section 69A):

Mortgagee having the right to exercise a power of sale under section 69 is entitled to appoint a receiver of the income of the mortgaged property or any part thereof.

(e) Right to accession to mortgaged property (section 70):

Accession made to mortgaged property after date of mortgage gives mortgagee the right to such accession.

(f) Right to the benefit of the renewed lease (Section 71):

Where the mortgaged property is a lease, and the mortgagor obtains a renewal of the lease, the mortgagee, in the absence of a contract to the contrary, shall for the purposes of the security be entitled to the new lease.

(g) Right of mortgagee in possession (Section 72):

A mortgagee can spend money for preservation of mortgaged property from destruction, forfeiture or sale; for supporting mortgagors title to the property; for making his own title thereto good against the mortgagor; and when the mortgaged property is a renewable leasehold, for the renewal of the lease. Such money spent can be added to the principal money at the rate of interest payable on the principal.

(h) Obligation of mortgagee in possession (Section 76):

The mortgagee during possession of the mortgaged property has to:

i. manage property as a person of ordinary prudence would manage;
ii. collect the rents and profits thereof;
iii. pay Government revenue, all other charges of a public nature and all rent accruing due in respect thereof during such possession,
iv. make necessary repairs of property as he can pay for out of the rent and profits;
v. not commit any act which is destructive or permanently injurious to the property;
vi. in case the property is insured and there is a loss or damage, apply any money which he receives under the policy, or so much thereof as may be necessary in re-instating the property, or, if the mortgagor so directs, in reduction of discharge of the mortgage money;
vii. Keep clear, full and accurate accounts of all sums received and spent by him as mortgagee.

(i) Liability to bring one suit on several mortgages (Section 67A):

Section 67A, Transfer of Property Act provides that a mortgagee who holds two or more mortgages executed by the same mortgagor in respect of each of which he has a right to obtain the same kind of decree under section 67 and who sues to obtain such decree on any one of the mortgages, shall, in the absence of a contract to the contrary, be bound to sue on all the mortgages in respect of which the mortgage money has become due.

17.6 CHARGE

Section 100 of the Transfer of Property Act 1882 defines charge. As per it, in cases where the immovable property of a person is made security for payment of money to another

and the transaction does not amount to mortgage, the person to whom security is provided is said to have a charge on the property. The act of making an immovable property security for payment of money could be either by an act of the parties or by operation of law. Section 100 further provides that all the provisions which apply to simple mortgage are applicable in case of creation of charge on a property. Section 100 excludes charge of a trustee on the trust property for expenses incurred in execution of trust from its operation. Also, charge cannot be enforced against any property transferred for consideration without notice of such charge.

Charges are of 2 types:

Fixed Charge: Fixed charges are created against specific and clearly identifiable property. Once a charge is created on such a property, such property can only be transferred subject to the charge. The charge holder will have a priority over others in case of disposal of the property.

Floating Charge: In case of a floating charge, the charge attaches to a definite property but the nature of charge is fluctuating. Only upon the crystallization of charge, does the floating charge become fixed. While the charge is floating in nature, the property holder is free to deal with it in any manner but once the charge becomes fixed, then the charge-holder has a priority and the property cannot be disposed off till the charge-holder is paid. Often banks lend money on the assets (securities) of a company and secure their loan transactions by creating a charge on the company's securities. In such cases, the charge is of floating nature unless the banks take some steps to crystallize the charge. One method by which charge can be crystallized is by appointing a Receiver. Also, in case of a going concern, a floating charge becomes fixed when the company goes into liquidation or ceases to carry-on business. Crystallization of a floating charge can also occur once the bank takes some steps which effects the security charged. Other than these, the agreement creating charge can specify some events on the happening of which charge may crystallize such as upon giving notice to the charge etc.

17.7 CORPORATE SECURITIES

Corporate securities are also used as collateral to secure loans and other transactions by banks. Corporate securities include debt securities such as bonds, debentures, deposits, commercial papers etc. Equity securities such as shares and stocks of companies are also used as collateral. We also have a number of securities which classify as hybrid securities having the characteristics of both debt and equity instruments. These include preference shares, equity warrants, convertibles etc.

[A detailed discussion on corporate securities is already done in the previous part]

17.8 DOCUMENT OF TITLE TO GOODS

Sale of Goods Act 1930, under Section 2(4), defines 'document of title to goods'. It provides that document of title to goods include:

(a) Bill of lading, dockwarrant, warehouse keeper's certificate, wharfinger's certificate, railway receipt, multimodal transport document, warrant or order for delivery of goods and any other document used in ordinary course of business

(b) Said document should be proof of possession or control of goods or authorising or purporting to authorise either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented.

In *Ellerman and Bucknall Steamship Co. Ltd.* v. *Sha Misrimal Bherajee* [AIR 1966 SC 1892], Court defined a clean bill of lading as one which does not contain any reservation/condition about the order and conditions of the goods. 'Condition' includes both apparent and non-apparent conditions.

The document of title to goods entitles the holder to deal with the goods represented by it as if he was the owner. The said document is proof of ownership, possession and control of goods. The possessor of the goods can receive the goods and can also transfer the goods to another person by mere delivery or endorsement and delivery. These documents are taken as security for advances by banks. Before accepting such documents, banker should verify the authenticity of said documents and should accept the same only from reliable sources. The goods contained in the document must be insured and the document should not have any adverse remark on face of it.

17.9 LAND AND BUILDINGS

Land and buildings are used as security by banks for advancing loans. It is also often used by banks for providing its overdraft facilities. Banks usually provide loans against the security of unencumbered land and building. In most cases banks are careful about the age of the property (residential/commercial). Banks also insist upon the personal guarantee of the owners of property. Besides these, banks can ask for third party guarantee. In case of loan proposals involving real estate, Reserve Bank has issued a number of circulars. As per Reserve Bank directive, before advancing loan to entities engaged in real estate, banks should look for prior permission from government/local government/ other statutory authorities for the project for which loan is sought. Disbursements should be made only after borrowers obtain required clearances from government authorities.

17.10 BOOK DEBTS OF ACCOUNT RECEIVABLES

Account receivable means money due for goods or service purchased on credit. These are current assets and the payment period is usually short. As the sale has been made but the money has not been received, the business entity is short of working capital and requires financial support of bank to meet its working capital requirement. However, banks face a number of disadvantages while lending against book debts. This is because banks find it difficult to keep track of book debts. Also, in case of default, bank is unable to bring the claim directly against the borrower's defaulter. Because of these risks, books debts are considered to be an inferior type of security. Often, it is taken as a collateral security.

17.11 LIFE POLICIES

Banks provide advances against securities of life insurance policies. Banks usually provide demand loan and overdraft facility against such security. For the purpose of advancing loans, banks usually fix a margin which is a percentage of the surrender value. Margin is usually influenced by the maturity period of the insurance policy. The repayment period is fixed with reference to the maturity date of policy.

17.12 FACTORING

Factoring refers to financing of account receivables. It can either be in domestic trade or both in domestic and international trade. Banks provide factoring services. Under these services, the client of the bank, sells the account receivables to the factor at a discount. The factor in return supplies the working capital needs of the client. When factor takes the invoices raised on open account sales of goods and services, the underlying risk may or may not be accepted. Usually the factor would insist upon credit protection. Banks usually charge a service fee for the service.

Under domestic factoring, banks can finance receivables from buyers and also finance the vendors and the suppliers. In international factoring, export factor will finance the exporter and along- side there will be import factor for ensuring protection against default, timely collection of money etc.

17.13 BILL DISCOUNTING

In case of bill discounting, bank purchases the bill (Bill of Exchange or Promissory Note) before it is due and credits the same to the customer's account after a discount charge. The amount of discount will depend on the amount of time left on bill maturity. It will also be determined on the basis of risk attached to the bill. Banks usually insist upon fulfilment of

certain conditions. Banks usually accept only trade bills. Further, the bill should have been accepted and its genuineness should be guaranteed via signatures of respective individual.

Master Circular- Loans and Advances lays down norms on discounting/rediscounting of bills by banks. Some of the key guidelines are:

(a) Banks can decide bills limit to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.

(b) Banks should lay down a bills discounting policy approved by their Board of Directors.

(c) Banks may review their core operating processes and simplify the procedure in respect of bills financing.

(d) Banks should open letters of credit (LCs) and purchase / discount / negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.

(e) Banks should not extend fund-based (including bills financing) or non-fund based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or / and non-constituent member of a consortium / multiple banking arrangement.

(f) If beneficiary of LC wants to discount the bills with the LC issuing bank itself, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary.

(g) Bills purchased / discounted / negotiated under LC (where the payment to the beneficiary is not made 'under reserve') will be treated as an exposure on the LC issuing bank and not on the borrower.

(h) In cases where the bills discounting/ purchasing/ negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/ borrower and not on the LC issuing bank.

(i) While purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions / documents.

(j) Banks should not, therefore, open LCs and purchase / discount / negotiate bills bearing the 'without recourse' clause.

(k) Accommodation bills should not be purchased / discounted / negotiated by banks.

(l) Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

(m) Bills rediscounts should be restricted to usance bills held by other banks.

17.14 BANK GUARANTEES

Bank guarantees are instruments issued by banks wherein bank undertakes to stand guarantee for other party's act. In case the party for which bank undertakes the obligation fails to discharge its liability to the party to whom the guarantee is given, bank as the guarantor has to fulfil/ discharge such liability. As regards bank, the guarantee is for payment of some money and such amount is known as the 'guarantee amount'. The person/entity for which guarantee is given is known as the 'applicant' and the person/entity to whom guarantee is given is known as the 'beneficiary'. Once the beneficiary claims discharge of liability undertaken by the guarantor, it is known as 'invocation' of guarantee. Bank guarantees can be of various types such as bid bond guarantee, advance payment guarantee, Loan guarantee, Guarantee for warranty obligation, performance guarantee, deferred payment guarantee, shipping guarantee, trade credit guarantee, standby LC etc. In case the bank fails to honour its liability under the guarantee, the beneficiary can claim compensation for deficiency in services besides fulfilment of promise under such guarantee. However, for a bank to be liable for deficiency of services, the demand has to be made according to the terms of the guarantee.

Banks usually offer both local and foreign currency bank guarantees and ask for some collateral as security. Bank guarantees have almost universal acceptance and governmental agencies and all major corporate accept it. Banks have to be careful while standing as a guarantor and usually has a policy in place in this regard. Few of the precautions generally taken by bank include insisting upon collateral/ fixed deposits of the full amount of guarantee and creating a charge/lien upon such security, verification of authenticity of customer (banks are more inclined to accept such requests from regular customers who have a long time association with the bank), fixing an upper cap on the maximum amount for which bank can issue guarantee, total amount of bank guarantee not exceeding the owned funds of the bank etc. Banks charge a commission for standing as a guarantor. Banks have to comply with Reserve Bank Regulations issued in this behalf from time to time. Banks can also demand execution of a demand promissory note to the extent of the guarantee amount in favour of the bank. Another precaution which can be insisted upon by banks is execution of a counter guarantee by the applicant in favour of the bank.

17.15 LETTER OF CREDIT

Letter of credit is a written undertaking given by a bank to the seller at the request and in accordance with the terms set by the buyer of effecting payment up to a specified amount. The bank issuing such letter of credit is known as the issuing bank and the person/seller to

whom such letter of credit is given is known as the beneficiary. The buyer on behalf of whom such letter of credit is issued is known as the applicant. Letter of credit gives the beneficiary the right to demand payment from the bank of the amount stated in such letter and the bank is under an obligation to make payment or accept or negotiate bills of exchange submitted by the beneficiary up to the stated amount.

Letters of credit are a convenient mode of making payment. In case of business transactions, both parties insist upon performance of their part of the contract and the party making the payment is wary of making payment until the contract is duly performed. The other party fears non payment despite performance of the contract. In such circumstances, to assure payment, sellers and buyers can opt for payment via letter of credit wherein bank undertakes the liability to pay the beneficiary of the amount stipulated under the letter of credit. The beneficiary is assured of getting the payment via the bank. Letter of credit is especially useful where the parties are unknown to each other or in case there are doubts regarding the creditworthiness of the buyer or in case of shipment to foreign countries. Letters of credit again can be either revocable or irrevocable and the seller in such cases to secure his position will insist upon issue of irrevocable letter of credit as revocable letters of credit can be cancelled or amended by the issuing bank without notice to the beneficiary. In case of irrevocable letters of credit, the issuing bank cannot cancel or amend the said letter of credit without the permission of beneficiary. Further letter of credit can be sight letter of credit wherein the beneficiary gets payment immediately upon presentation or usance wherein a date is mentioned for payment. Such date is determined on the basis of the sales contract between the applicant and the beneficiary. Lastly, letter of credit can be confirmed or unconfirmed. In case of confirmed letter of credit, a local bank of the beneficiary undertakes the liability giving beneficiary the advantage of dealing with a local bank. In case of unconfirmed letter of credit, the issuing bank has to honour all obligations under it in the first instance.

Letters of credit are a convenient mode of making payment both for the seller and the buyer. The seller is assured of a secured mechanism of payment. Banks also often provide expert advice on export transactions and various other financing options such as pre-shipment finance. Buyer is able to withhold payment till the terms and conditions of the contract incorporated in the letter of credit are complied with. Further, the buyer is able to keep his cash reserves free till the time of payment.

In *Federal Bank Ltd.* V. V.M. Jog Engineering Ltd. [AIR 2000 SC 3166], Court held that the contract between the issuing banker and the paying or negotiating (intermediary)

banker can be of dual nature. Primarily, the relationship is of principal and agent, mandatory and mandatory. For claiming reimbursement for any payment made, intermediary bank has to fully comply with the instructions received. Once the intermediary bank acts on such instructions he impliedly accepts those instructions and a contractual relationship with the issuing bank starts. The instructions issued may be varied ranging from authority to make payment against documents or drafts accompanied by documents, negotiation of drafts etc. The Court further held that though there is ordinarily no privity between the intermediary banker and the buyer, the intermediary banker though initially an agent of the Issuing banker can act as principal in relation to him. In *Federal Bank Ltd.* v. *V.M. Jog Engineering Ltd.* [AIR 2000 SC 3166], Court while deciding upon the liability of honouring documentary credit held that the Uniform Customs and Practices for Documentary Credits formulated by the International Chamber of Commerce provides that "General provisions and Definitions and the Article following are to apply to all documentary credit and binding upon all parties thereto unless otherwise expressly agreed". UCP further states that it shall be deemed incorporated into each documentary credit if there are words in the credit indicating that such credit was issued subject to Uniform Customs and Practices for Documentary Credits. It was further held that in the absence of incorporation, UCP will not apply. Despite that, UCP can be taken into account as part of mercantile customs and practices as most of it is part of common law.

17.16 COMMERCIAL PAPERS

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. It was introduced in India in 1990 for enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Later, primary dealers and all-India financial institutions were also permitted to issue CP. The corporates, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP. All corporate are not automatically eligible to issue CP. A corporate would be eligible to issue CP provided – (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore; (b) company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s/ institution/s.

All eligible participants shall obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the

Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank from time to time, for the purpose. The minimum credit rating required shall be A-2. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

Following are some of the striking aspects of CP

- CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.
- The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower.
- CP can be issued in denominations of Rs. 5 lakh or multiples thereof.
- The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription.
- CP may be issued on a single date or in parts on different dates by the same issuer.
- Only a scheduled bank can act as an IPA for issuance of CP.
- Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs.
- CP can be issued either in the form of a promissory note or in a dematerialised form through any of the depositories approved by and registered with SEBI.
- CP is issued at a discount to face value as may be determined by the issuer.
- No issuer shall have the issue of Commercial Paper underwritten or co-accepted.
- CPs can be traded in the OTC market.
- On maturity of CP, (a) when the CP is held in physical form, the holder of the CP shall present the instrument for payment to the issuer through the IPA; (b) when the CP is held in demat form, the holder of the CP will have to get it redeemed through the depository and receive payment from the IPA.
- Non-bank entities including corporates can provide unconditional and irrevocable guarantee for credit enhancement for CP issue subject to conditions.
- Fixed Income Money Market and Derivatives Association of India (FIMMDA), may prescribe standardised procedure for functioning of CP market. Every CP issue should be reported to the Chief General Manager, Reserve Bank of India, Financial Markets Department within three days from the date of completion of the issue.

17.17 SUMMARY

One of the key functions of banks is to advance loans and charge an interest upon it. This interest is the earning of the bank. However, in a number of cases, there might be default upon loan repayment and in such cases the loans advanced become a non-performing asset of the banks. In such circumstances, rather than becoming a source of income for the banks, loans become liabilities on part of the banks. This makes it necessary that banks should adopt a cautious attitude before advancing loans and the creditworthiness of the borrower should be firmly established. Guarantees are such a form of security for loans advanced by banks and are provided under the Indian Contract Act 1872. Pledge is another mode by which banks secure their loans. Section 172 of Indian Contract Act 1872 defines pledge as the bailment of goods as a security for payment of a debt or performance of a promise.

Another form of security is lien. Lien is the right of the bailee to retain possession of goods or any other security held by him until the repayment of his debt. The right of lien gives the creditor to keep goods or any security in his possession until the debt is paid. Mortgage is another mode adopted by banks to secure their loans. In case of mortgage, an interest in a specific immovable property is transferred for securing the money advanced or any other obligation of pecuniary nature. The person who transfers his interest in the property is known as the mortgagor and the transferee (in this case, the bank) is known as the mortgagee. Besides these, banks can also create a charge. Section 100 of the Transfer of Property Act 1882 defines charge. As per it, in cases where the immovable property of a person is made security for payment of money to another and the transaction does not amount to mortgage, the person to whom security is provided is said to have a charge on the property.

Corporate securities are also used as collateral to secure loans and other transactions by banks. Corporate securities include debt securities such as bonds, debentures, deposits, commercial papers etc. Equity securities such as shares and stocks of companies are also used as collateral. Land and buildings are also used as security by banks for advancing loans. It is also often used by banks for providing its overdraft facilities. Banks usually provide loans against the security of unencumbered land and building. Banks can also provide advances against securities of life insurance policies. Banks usually provide demand loan and overdraft facility against such security. For the purpose of advancing loans, banks usually fix a margin which is a percentage of the surrender value.

Banks provide a number of secondary services such as factoring, bill discounting, standing as a guarantor and providing letter of credit. Factoring refers to financing of account

receivables. It can either be in domestic trade or both in domestic and international trade. In case of bill discounting, bank purchases the bill (Bill of Exchange or Promissory Note) before it is due and credits the same to the customer's account after a discount charge. The amount of discount depends on the amount of time left on bill maturity. Bank guarantees are instruments issued by banks wherein bank undertakes to stand guarantee for other party's act. In case the party for which bank undertakes the obligation fails to discharge its liability to the party to whom the guarantee is given, bank as the guarantor has to fulfil/ discharge such liability. As regards bank, the guarantee is for payment of some money and such amount is known as the 'guarantee amount'. Letter of credit is a written undertaking given by a bank to the seller at the request and in accordance with the terms set by the buyer of effecting payment up to a specified amount. The bank issuing such letter of credit is known as the issuing bank and the person/seller to whom such letter of credit is given is known as the beneficiary.

17.18 KEY WORDS

1. Guarantee
2. Pledge
3. Lien
4. Mortgage
5. Charge
6. Corporate Securities
7. Document of Title to Goods
8. Land
9. Building
10. Book Debts
11. Life policies
12. Factoring
13. Bill Discounting
14. Bank Guarantee
15. Letter of Credit
16. Commercial papers

17.19 SELF ASSESSMENT QUESTIONS

1. Elaborate on the norms regulating guarantees as contained in Indian Contract Act 1872.

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2. What is pledge? How does Indian Contract Act regulate it?

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3. Explain lien as a means of securing the loans.

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4. What are the different kinds of mortgage? Discuss the rights and liabilities of the mortgagor and mortgagee?

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5. Define charge. Mention the different types of charge.

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   ....

6. What is bill discounting? Point out the Reserve Bank guidelines on bill discounting.

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   ....

7. Write explanatory notes on
   (a) Bank Guarantees
   (b) Letter of Credit.
   (c) Commercial papers

17.20 REFERENCES

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UNIT-18: SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTERESTS ACT 2002

Structure:

18.0 Objectives

18.1 Introduction

18.2. Key definitions in sarfaesi act 2002

18.3. Regulation of securitization and reconstruction of financial assets of banks and financial institutions

18.4. Enforcement of security interest

18.5. Central registry

18.6. Offences and penalties

18.7. Limits on the application and jurisdiction

18.8 Summary

18.9 Key words

18.10 Self Assessment Questions

18.11 References

18.0 OBJECTIVES

- To know the objective behind enactment of SARFAESI Act.
- To understand the key provisions under the Act with special emphasis upon regulation of securitization and Reconstruction of Financial Assets of Banks and Financial institutions.
- To able understand the various offences and penalties under the Act.

18.1 INTRODUCTION

SARFAESI ACT was passed in 2002 to check rising incidences of Non Performing assets (NPAs). It was based on the recommendations of Narasimham Committee II and Andhyarujina Committee, which suggested enactment of a new legislation to check NPAs. The Act allows banks and Financial Institutions to take possession of securities and sell them. The Act legalises securitisation and reconstruction of financial assets and enforcement of security interest and establishes asset reconstruction companies (ARCs)/ Securitisation Companies (SCs). It also has provisions for registration and regulation of securitisation companies or reconstruction companies by the Reserve Bank.

Three methods for recovery of NPAs are provided under the Act:

Securitisation: Securitisation means acquisition of financial assets by any securitisation company or reconstruction company from any originator.

Asset Reconstruction: Asset reconstruction means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance. This includes:

(a) Management of business of the borrower.
(b) Sale or lease of the business of the borrower.
(c) Rescheduling of payment of debts payable by the borrower.
(d) Enforcement of security interest.
(e) Settlement of dues payable by the borrower.
(f) Taking possession of secured assets.

Exemption from registration of security receipt: The Act under Section 8 provides that any security receipt issued by the securitisation company or reconstruction company not creating, declaring, assigning, limiting or extinguishing any right, title or interest, to or in immovable property or any transfer of security receipts shall not require compulsory registration.

18.2. KEY DEFINATIONS IN THE SARFAESI ACT 2002 (Section 2)

'Asset reconstruction' means acquisition by any securitisation company or reconstruction company of any right or interest of any bank or financial institution in any financial assistance for the purpose of realisation of such financial assistance [Section 2(b)]

'Financial asset' means debt or receivables and includes--

(i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or
(ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or
(iii) a mortgage, charge, hypothecation or pledge of movable property; or
(iv) any right or interest in the security, whether full or part underlying such debt or receivables; or
(v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or
(vi) any financial assistance. [Section 2(l)]

'Non-Performing Asset' means an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset,--

(a) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;
(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank. [Section 2(o)]

'Securitisation' means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise. [Section 2(z)]

18.3 REGULATION OF SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS OF BANKS AND FINANCIAL INSTITUTIONS

Registration of Securitization Companies or Reconstruction Companies:

Section 3 provides for registration of securitisation companies or reconstruction companies. To carry on the business of securitisation or asset reconstruction, such companies

need to have a certificate of registration and owned fund of not less than two crore rupees or an amount not exceeding fifteen per cent of total financial assets acquired by the securitisation company or reconstruction company. Reserve Bank has the authority to impose a number of conditions for considering the application for registration. Few of the conditions are -

(a) That the securitisation company or reconstruction company has not incurred losses in any of the three preceding financial years;

(b) That such securitisation company or reconstruction company has made adequate arrangements for realisation of the financial assets acquired for the purpose of securitisation or asset reconstruction.

(c) That the directors of securitisation company or reconstruction company have adequate professional experience in matters related to finance, securitisation and reconstruction;

(d) That any of its directors has not been convicted of any offence involving moral turpitude;

(f) That a sponsor, is not a holding company of the Securitisation Company or reconstruction company.

The Reserve Bank can, if it is satisfied, grant a certificate of registration to the securitisation company or the reconstruction company.

A certificate of registration granted to a securitisation company or a reconstruction company can be cancelled under Section 4. Some of the conditions under which it can be cancelled are the followings.

(a) If the company ceases to carry on the business of securitisation or asset reconstruction; or

(b) If the company ceases to receive or hold any investment from a qualified institutional buyer; or

(c) If the company has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or

(d) If the company fails to comply with any direction issued by the Reserve Bank under the provisions of this Act; or maintain accounts in accordance with the requirements etc.

A securitisation company or reconstruction company aggrieved by the order of cancellation of certificate of registration may prefer an appeal within a period of thirty days

from the date on which such order of cancellation is communicated to it to the Central Government.

Acquisition of rights or interest in financial assets:

Any securitisation company or reconstruction company can acquire financial assets of any bank or financial institution-- (a) By issuing a debenture or bond or any other security in the nature of the debenture, for consideration; or (b) By entering into an agreement with such bank or financial institution for the transfer of such financial assets to such company (Section 5).

Under Section 6, the bank or financial institution can give a notice of acquisition of financial assets by any securitisation company or reconstruction company to the concerned obligor. The obligor on receipt of such notice shall make payment to the concerned securitisation company or Reconstruction Company in discharge of any of the obligations in relation to the financial asset specified. If no notice of acquisition of financial asset is given by any bank or financial institution, any money or other properties subsequently received by the bank or financial institution shall constitute monies or properties held in trust for the benefit of and on behalf of the securitisation company or reconstruction company.

Issue of security by raising of receipts or funds by securitisation company or reconstruction company:

Any securitisation company or reconstruction company can after acquisition of any financial asset offer security receipts to qualified institutional buyers for subscription. A securitisation company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets. The scheme for the purpose of offering security receipts or raising funds may be in the nature of a trust to be managed by the securitisation company or reconstruction company (Section 7).

Any security receipt issued by the securitisation company or reconstruction company and not creating, declaring, assigning, limiting or extinguishing any right, title or interest, to or in immovable property or any transfer of security receipts shall not require compulsory registration (Section 8).

Measures for assets reconstruction (Section 9):

A securitization company or reconstruction company can for the purposes of asset reconstruction provide for any of the following measures, namely:--

(a) The proper management of the business of the borrower.

(b) The sale or lease of a part or whole of the business of the borrower;

(c) Rescheduling of payment of debts payable by the borrower;

(d) Enforcement of security interest.

(e) Settlement of dues payable by the borrower;

(f) Taking possession of secured assets.

According to Section 11, in case of any dispute relating to securitisation or reconstruction or non-payment of any amount due such dispute shall be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act 1996. Sections 12 and 12A confer certain important powers to the Reserve Bank. The Reserve Bank, under Section 12, can determine the policy and give directions to all or any securitisation company or reconstruction company in matters relating to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy based on risk weights for assets and also relating to deployment of funds by the securitisation company or reconstruction company. Under Section 12A, the Reserve Bank is entitled to direct a securitisation company or reconstruction company to furnish statements and information relating to the business or affairs of such securitisation company or reconstruction company.

18.4 ENFORCEMENT OF SECURITY INTEREST

Section 13 provides for enforcement of security interest. It provides that any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor in accordance with the provisions of this Act. If any borrower makes any default in repayment of secured debt the secured creditor may require the borrower to discharge his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor can take any of the following measures –

(a) Take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;

(b) Take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset:

(c) Appoint any person to manage the secured assets the possession of which has been taken over by the secured creditor;

(d) Require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt.

Any transfer of secured asset after taking possession thereof or takeover of management shall vest in the transferee all rights in, or in relation to, the secured asset transferred as if the transfer had been made by the owner of such secured asset. If the dues of the secured creditor are tendered to the secured creditor at any time before the date fixed for sale or transfer, the secured asset shall not be sold or transferred by the secured creditor. In the case of financing of a financial asset by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any or all of the rights conferred on him under unless exercise of such right is agreed upon by the secured creditors representing not less than three-fourth in value of the amount outstanding as on a record date. Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, the secured creditor may file an application to the Debts Recovery Tribunal for recovery of the balance amount from the borrower. The secured creditor shall be entitled to proceed against the guarantors or sell the pledged assets without first taking any of the measures specified above. Borrower after receipt of notice shall not transfer by way of sale, lease or otherwise any of his secured assets without prior written consent of the secured creditor.

Section 14 provides that the Chief Metropolitan Magistrate or District Magistrate will assist the secured creditor in taking possession of secured asset and shall (a) Take possession of such asset and documents relating thereto; and (b) Forward such assets and documents to the secured creditor. No managing director or any other director or a manager or any person in charge of management of the business of the borrower shall be entitled to any compensation for the loss of office or for the premature termination (Section 16).

Any person aggrieved by any of the measures taken by the secured creditor can appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five days from the date on which such measure had been taken (Section 17). Any person aggrieved, by any order made by the Debts Recovery Tribunal under section 17, may prefer an appeal to the Appellate Tribunal within thirty days from the date of receipt of the order of Debts Recovery Tribunal. The borrower has the right to receive compensation and costs in case the Debts Recovery Tribunal or the Appellate Tribunal holds that the possession of secured assets by the secured creditor is not in accordance with the provisions of this Act (Section 19).

18.5 CENTRAL REGISTRY

Section 20 of the Act provides for setting up of a registry to be known as the Central Registry for registration of transaction of securitisation and reconstruction of financial assets

and creation of security interest under this Act. The territorial limit of the registry is defined by the Central government. Section 21 provides for appointment of Central Registrar for registering transactions relating to securitisation, reconstruction of financial assets and security interest created over properties. Section 22 provides for a record called the Central Register to be kept at the head office of the Central Registry for entering the particulars of the transactions relating to- (a) Securitisation of financial assets; (b) Reconstruction of financial assets; and (c) Creation of security interest.

Section 23 provides that the particulars of every transaction of securitisation, asset reconstruction or creation of security interest shall be filed, with the Central Registrar within thirty days after the date of such transaction or creation of security by the securitisation company or Reconstruction Company or the secured creditor. The securitisation company or Reconstruction Company or the secured creditor has to inform the Central Registrar of the payment or satisfaction of any security interest relating to the securitisation company or the reconstruction company or the secured creditor (Section 25). The particulars of securitisation or reconstruction or security interest entered in the Central Register shall be open during the business hours for inspection by any person on payment of fee (Section 26).

18.6 OFFENCES AND PENALTIES

Section 27, 28 and 29 prescribe for penalties for different offences under the Act. For default in filing the particulars of every transaction of any securitisation or asset reconstruction or security interest created by a securitisation company or reconstruction company or secured creditor, every company and every officer of the company or the secured creditor and every officer of the secured creditor in default shall be punishable with fine which may extend to five thousand rupees for every day during which the default continues. If any securitisation company or reconstruction company fails to comply with any direction issued by the Reserve Bank, such company and every officer of the company who is in default, shall be punishable with fine which may extend to five lakh rupees and in the case of a continuing offence, with an additional fine which may extend to ten thousand rupees for every day during which the default continues.

If any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules made there under, he shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both. If an offence has been committed by a company, every person who at the time the offence was

committed was in charge of, and was responsible to, the company, for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly under Section 33. Section 30 provides that no court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of the First Class shall try any offence punishable under the Act.

18.7 LIMITS ON THE APPLICATION AND JURISDICTION

As per Section 31, provisions of the Act are not applicable to -

(a) lien on any goods, money or security given by or under the Indian Contract Act, 1872 or the Sale of Goods Act, 1930 or any other law for the time being in force;

(b) A pledge of movables within the meaning of section 172 of the Indian Contract Act, 1872;

(c) Creation of any security in any aircraft as defined in clause (1) of section 2 of the Aircraft Act, 1934;

(d) Creation of security interest in any vessel as defined in clause (55) of section 3 of the Merchant Shipping Act, 1958;

(e) Any conditional sale, hire-purchase or lease or any other contract in which no security interest has been created;

(f) Any rights of unpaid seller under section 47 of the Sale of Goods Act, 1930;

(g) Any properties not liable to attachment or sale under the first proviso to sub-section (1) of section 60 of the Code of Civil Procedure, 1908;

(h) Any security interest for securing repayment of any financial asset not exceeding one lakh rupees;

(i) Any security interest created in agricultural land;

(j) Any case in which the amount due is less than twenty per cent of the principal amount and interest thereon.

The secured creditor or the borrowers are protected against any action for acts done in good faith (Section 32). Section 34 provides that no civil court will have jurisdiction to entertain any suit or proceeding in respect of any matter which a Debts Recovery Tribunal or the Appellate Tribunal is empowered to determine. The Act has an overriding effect over other laws (Section 35). The Act does not bar the application of other laws. Section 37 provides that the provisions of the Act shall be in addition to the Companies Act 1956, the Securities Contracts (Regulation) Act 1956, the Securities and Exchange Board of India Act 1992, the Recovery of Debts Due to Banks and Financial Institutions Act 1993 or any other

law for the time being in force. Section 38 gives Central Government the power to make rules.

18.8 SUMMARY

SARFAESI ACT was passed in 2002 to check rising incidences of Non Performing assets (NPAs). It was based on the recommendations of Narasimham Committee II and Andhyarujina Committee which suggested enactment of a new legislation to check NPAs. The Act allows banks and Financial Institutions to take possession of securities and sell them. The Act legalises securitisation and reconstruction of financial assets and enforcement of security interest and establishes asset reconstruction companies (ARCs)/ Securitisation Companies (SCs). It also has provisions for registration and regulation of securitisation companies or reconstruction companies by the Reserve Bank.

Section 3 provides for registration of securitisation companies or reconstruction companies. To carry on the business of securitisation or asset reconstruction, such companies need to have a certificate of registration and owned fund of not less than two crore rupees or an amount not exceeding fifteen per cent of total financial assets acquired by the securitisation company or reconstruction company. Reserve Bank has the authority to impose a number of conditions for considering the application for registration.

Section 13 provides for enforcement of security interest. It provides that any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor in accordance with the provisions of this Act. If any borrower makes any default in repayment of secured debt the secured creditor may require the borrower to discharge his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor can take various measures. Section 20 of the Act provides for setting up of a registry to be known as the Central Registry for registration of transaction of securitisation and reconstruction of financial assets and creation of security interest under this Act. The territorial limits of the registry will be defined by the Central government. Section 27, 28 and 29 prescribe for penalties for different offences under the Act.

18.9 KEY WORDS

1. SARFAESI Act
2. Securitization
3. Reconstruction
4. Financial Assets

5. Security Interest
6. Central Registry
7. Offences
8. NPAs
9. Borrower
10. Debt
11. Debts Recovery Appellate Tribunal
12. Default
13. Magistrate

18.10 SELF ASSESSMENT QUESTIONS

1. What are the reasons behind the passing of SARFAESI Act?

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2. What are the different methods of recovery of NPAs provided under the Act?

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3. What do you mean by 'Asset Reconstruction' and 'Financial Asset'?

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4. Briefly discuss the norms relating to registration of securitization or reconstruction companies. Under what circumstances can the Certificate of registration be cancelled?

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5. Elaborate on the procedure laid down under the SARFAESI Act for the enforcement of security interests.

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18.11 REFERENCES

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UNIT-19: THE BANKING OMBUDSMAN SCHEME

Structure:

19.0 Objectives
19.1 Introduction
19.2. Details of banking ombudsman scheme
19.2.1 Grounds of Complaint
19.2.2 Grounds on which Complaints can be Rejected
19.2.3. Procedure for Filing Complaint
19.2.4 Procedure after Receipt of Complaint
19.3 Recovery of debts due to banks and financial institutions act 1993
19.3.1 Jurisdiction, Powers and Authority of Tribunals
19.3.2 Procedure of Tribunals
19.3.3 Recovery of Debts Determined by Tribunal and Miscellaneous Provisions
19.4. The banker's book evidence act 1891
19.5 Summary
19.6 Key words
19.7 Self Assessment Questions
19.8 References

19.0 OBJECTIVES

- To understand the Banking Ombudsman Scheme.
- To analyse the relevant provisions of Recovery of Debt Due to Banks and Financial Institutions Act 1993.
- To able to understand the key provisions of Bankers Book Evidence Act 1891.

19.1 INTRODUCTION

This Unit deals with three important legislation relating to the banking business; Banking Ombudsman Scheme, Recovery of Debt Due to Banks and Financial Institutions Act 1993 and Bankers Book Evidence Act 1891. The aim of Banking Ombudsman Scheme is to facilitate resolution of complaints relating to certain services offered by banks. The scheme has been introduced since 1995 under Section 35A of the Banking Regulation Act 1949. Section 35A provides that the Reserve Bank has power to issue directions to banking companies, if it feels that such directions are necessary in public interest or in the interest of banking policy or for ensuring proper management of banking companies generally. These directions are mandatory and the banking companies are bound to comply.

The Recovery of Debt Due to Banks and Financial Institutions Act 1993 is introduced to secure the recovery of debts and to provide tribunals for expeditious adjudication in this regard. The modes of recovery provided under the Act have been instrumental in building the confidence of the banks. The Bankers Book Evidence Act 1861 details out the evidentiary value of the 'Bankers Books' in the legal proceedings.

19.2. DETAILS OF BANKING OMBUDSMAN SCHEME

Purpose and Details of Scheme:

The purpose of the scheme is to provide a forum wherein bank customers can bring up their complaints against certain services rendered by banks. For this purpose, a Banking Ombudsman is appointed who is generally a senior officer entrusted with the task of looking into complaints of deficiency in services. Around 15 Banking Ombudsmen have been appointed so far. The scheme covers all the Scheduled Commercial banks, Regional Rural banks and Scheduled Primary Co-operative banks. Before making a complaint, a complaint has to be made to the concerned bank and only if no reply is received from the bank within a period of one month or the bank rejects the complaint or the complainant is not satisfied with the reply received, a complaint can be brought before the Ombudsman. Complaints can be filed by the person dissatisfied with the bank's service or his legal representatives. Lawyers cannot act as the authorized representatives. No fee is charged for filing the complaint. Under

the scheme, compensation amount is limited to the amount which directly arises out of the act or omission of the bank. There is also an upper cap of Rs. 10 lakh as the maximum amount of compensation which can be given under the scheme. In case of complaints relating to credit cards, compensation not exceeding Rs 1 lakh can be provided to the complainant for mental agony and harassment.

In *Canara Bank* v. *P.R.N. Upadhyaya* [(1998) 94 Comp Cas 569], while deciding upon an appeal against an award made by the Banking Ombudsman, Court held that since the ombudsman is appointed by virtue of scheme framed under Section 35A of the Banking Regulation Act 1949, he is obliged to comply with directions/circulars and Notifications issued by the Reserve Bank of India.

19.2.1 Grounds of Complaint:

To start with the various services against which complaints can be brought have been specified under the scheme. These include –

(i) non-payment or inordinate delay in the payment or collection of cheques, drafts, bills etc.;

(ii) non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission in respect thereof;

(iii) non-acceptance, without sufficient cause, of coins tendered and for charging of commission in respect thereof;

(iv) non-payment or delay in payment of inward remittances;

(v) failure to issue or delay in issue of drafts, pay orders or bankers' cheques;

(vi) non-adherence to prescribed working hours;

(vii) failure to provide or delay in providing a banking facility (other than loans and advances) promised in writing by a bank or its direct selling agents;

(viii) delays, non-credit of proceeds to parties' accounts, non-payment of deposit or non-observance of the Reserve Bank directives, if any, applicable to rate of interest on deposits in any savings, current or other account maintained with a bank;

(ix) complaints from Non-Resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank-related matters;

(x) refusal to open deposit accounts without any valid reason for refusal;

(xi) levying of charges without adequate prior notice to the customer;

(xii) non-adherence by the bank or its subsidiaries to the instructions of Reserve Bank on ATM/Debit card operations or credit card operations;

(xiii) non-disbursement or delay in disbursement of pension (to the extent the grievance can be attributed to the action on the part of the bank concerned, but not with regard to its employees);

(xiv) refusal to accept or delay in accepting payment towards taxes, as required by Reserve Bank/Government;

(xv) refusal to issue or delay in issuing, or failure to service or delay in servicing or redemption of Government securities;

(xvi) forced closure of deposit accounts without due notice or without sufficient reason;

(xvii) refusal to close or delay in closing the accounts;

(xviii) non-adherence to the fair practices code as adopted by the bank or non-adherence to the provisions of the Code of Bank's Commitments to Customers issued by Banking Codes and Standards Board of India and as adopted by the bank;

(xix) non-observance of Reserve Bank guidelines on engagement of recovery agents by banks; and

(xx) any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

Complaints can also be brought for deficiency in services with respect to loans and advances on the following grounds:

(i) non-observance of Reserve Bank Directives on interest rates;

(ii) delays in sanction, disbursement or non-observance of prescribed time schedule for disposal of loan applications;

(iii) non-acceptance of application for loans without furnishing valid reasons to the applicant;

(iv) non-adherence to the provisions of the fair practices code for lenders as adopted by the bank or Code of Bank's Commitment to Customers, as the case may be;

(v) non-observance of any other direction or instruction of the Reserve Bank as may be specified by the Reserve Bank for this purpose from time to time; and

(vi) The Banking Ombudsman may also deal with such other matter as may be specified by the Reserve Bank from time to time.

19.2.2 Grounds on which Complaints can be rejected:

Complaints filed before the Banking Ombudsman can be rejected if:

(a) The Complainant has not approached the bank for redressal of his grievance.

(b) The complaint has not been made within one year from the date of receiving the reply of the bank or in case no reply is received, a period of more than one year one month has passed from the date of representation to the bank.

(c) Complaint is also liable to be rejected if the complaint is pending for disposal or has already been disposed by a court of law, consumer court or any other forum. A complaint would also be rejected if the complaint is on the same subject matter which has been previously settled by the Banking Ombudsman.

(d) Frivolous or vexatious complaints are rejected.

(e) For a valid complaint to be made the institution against which the complaint is made should be covered under the scheme and the subject matter of the complaint should be within the scheme.

(f) If compensation sought is beyond Rs. 10 lakh, the Banking ombudsman can reject the complaint.

(g) Complaint can also be rejected if the complaint is one which requires proceedings for which the banking Ombudsman is not the appropriate authority (detailed consideration of documentary and oral evidence).

(h) Banking ombudsman can reject the complaint if the complainant fails to pursue the complaint with reasonable diligence or if loss or damage or inconvenience is caused to the complainant.

19.2.3 Procedure for Filing Complaint:

A complaint can be filed by writing on a plain paper. It can also be field online. There is no fixed format and convenience of the consumer has been kept in mind by keeping the procedure very flexible. To file a complaint, one has to locate the Banking Ombudsman under whose jurisdiction the bank branch against whom complaint is sought to be made located. In case of services which are provided on a centralised basis, complaints can be made before the Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located. The scheme provides for the details which must be present in the complaint. These include: (i) Name and address of the complainant. (ii) Name and address of the branch or office of the bank against which the complaint is made. (iii) Facts relating to the complaint. (iv) Relevant documents in support of the complaint. (v) Nature and extent of loss caused to the complainant. (vi) Relief sought from the Banking Ombudsman. (vii) A declaration about compliance of conditions required to be complied with by the complainant.

19.2.4 Procedure after Receipt of Complaint:

The Ombudsman tries to settle the dispute by conciliation, mediation or settlement. In case the parties are able to arrive at a settlement, the Ombudsman passes an order to that effect and the terms of the settlement become binding on the bank and the complainant. In case the parties are not able to reach an agreement, the Ombudsman after hearing both the parties can pass an award. This award is voluntary in nature and the complainant can accept the award in full or reject it. If the complainant chooses to reject the award, the complainant can approach the Appellate Authority. This right is also available to the bank. However, such an appeal has to be made within 30 days of the award. The Appellate Authority can in certain cases give a further extension of 30 days. The Appellate Authority can either dismiss the appeal or allow it and set aside the award. It can also send the matter to the banking Ombudsman for fresh disposal with any directions it might think necessary to be given or can modify the award or pass any other orders it deems fit.

19.3 RECOVERY OF DEBTS DUE TO BANKS AND FINANCIAL INSTITUTIONS ACT 1993

Introduction

This Act was passed to help banks and other financial institutions in recovering loans and enforcing securities charged with loans. The Act was passed on the recommendations of a committee set up in 1981 to suggest measures to overcome the problems faced by banks and other financial institutions. The statement of objects and reasons of the Act points to the problem of ineffective procedure for recovery of debt due to banks and financial institutions leading to a lot of funds being locked. It also refers to the 1981 Tiwari Committee suggestions wherein it was suggested that Special Tribunals should be set up for recovery of dues of banks and financial institutions. These tribunals were to follow summary procedure to decide expediently huge number of pending cases, which was one of the chief reasons behind enactment of this Act. According to the figures quoted in the statement of object and reasons, on 30 September 1990, more than fifteen lakh cases filed by public sector banks and about 304 cases filed by financial institutions were pending in various courts. In these cases of recovery of debts more than ₹ 6000 crores were locked due to lengthy court processes. The aim of the Act is to establish Tribunals and Appellate Tribunals to create an expeditious forum for hearing of cases relating to recovery of debts due to banks and financial institutions.

Preliminary, Establishment of Tribunal and Appellate Tribunal

The Act which came into force on 24 June 1993 extends to the whole of India except the State of Jammu and Kashmir. The Act provides for establishment of Tribunals and Appellate Tribunals by the Central Government. Such Tribunals are to be known as Debt Recovery Tribunals and exercise all the powers conferred on them under the Act. The jurisdiction of these Tribunals is decided by notification by the Central Government. A Tribunal consists of a Presiding officer who is appointed by the Central Government. The Central Government can authorise the Presiding Officer of a Tribunal to discharge functions of the Presiding Officer of another Tribunal. Section 5 of the Act prescribes the qualifications for being appointed as Presiding officer. It provides that for appointment as Presiding Officer, a person has to be qualified to be a District Judge. Such Presiding Officer is to hold office for a term of five years from the date on which he enters his office or until he attains the age of sixty-two, which-ever is earlier. Central Government can appoint one or more Recovery Officers and other employees to assist the Presiding Officer. The Recovery Officer and other employees of the Tribunal would work under the superintendence of the Presiding Officer.

The Act also provides for establishment of Appellate Tribunals. These Appellate Tribunals which are to be known as Debts Recovery Appellate Tribunals exercise the jurisdiction, power and authority conferred upon them under the Act. The Appellate Tribunals have a Chairperson who is authorised by the Central Government to discharge the functions. The Chairperson of the Appellate Tribunal should be qualified to be a Judge of the High Court or should have been a member of the Indian Legal Service and has held a post in Grade I of that service for at least three years. A person holding office as Presiding Officer of a Tribunal for at least three years is also qualified to be the Chairperson of an Appellate Tribunal. The Chairperson of an Appellate Tribunal will hold office for a term of five years from the date he joins office or till the age of sixty-five years which-ever is earlier. The Presiding Officer of a Tribunal or the Chairperson of an Appellate Tribunal can be removed from office by the Central Government on ground of proved misbehaviour or incapacity. This can only be done upon inquiry which has to be conducted either by a Judge of a High Court (in case of the Presiding Officer of a Tribunal) or by a Judge of the Supreme Court (in case of the Chairperson of an Appellate Tribunal).

19.3.1 Jurisdiction, Powers and Authority of Tribunals

Section 17 of the Act provides for the jurisdiction and the powers of the Tribunal. It provides that the Tribunal has the jurisdiction and the power to entertain applications from banks and financial institutions for recovery of debts due to such banks and financial

institutions. The Appellate Tribunal has the jurisdiction and the power to entertain any appeal from the order made by a Tribunal. Section 17A further provides the powers of the Chairperson of appellate Tribunal. It provides that the Chairperson has the general power of superintendence and control over the Tribunal under his jurisdiction. This power includes the power of appraising the work and recording the annual confidential reports of the presiding Officers. The Chairperson also has the power to transfer any case from one Tribunal to any other Tribunal. Section 18 provides that no court or other authority other than the Supreme Court and a High Court exercising jurisdiction under Article 226 and 227 shall entertain any matter which falls under the jurisdiction of the Tribunals set up under this Act.

In *Allahabad Bank* v. *Canara Bank* [(2000) 101 Comp Cas 64], ruling upon the jurisdiction of the Debt Recovery Tribunal, Court held that the jurisdiction of the Debts Recovery Tribunal under the Recovery of Debts Due to Banks and Financial Institutions Act 1993 as regards adjudication of applications of banks and financial institutions is exclusive. Under the Act, Tribunal alone has the authority to decide applications for recovery of debts due to banks and financial institutions. Further, under Section 18 of the Act, jurisdiction of any other court or authority which would otherwise have had jurisdiction is ousted and the Tribunal is given the exclusive power to adjudicate upon the liability of Banks and Financial Institutions.

As regarding the jurisdiction of the Recovery Officer on execution, the Court held that it is exclusive. Certificate granted under section 19(22) has to be executed only by the Recovery Officer, since provisions of section 34(1) clearly provide that the Act overrides other laws to the extent of 'inconsistency'. Court further held that a bank or financial institution need not seek leave of the company court to proceed with its claim before the Debt Recovery Tribunal. Same is the case for execution proceedings before the Recovery Officer against a company in liquidation. The proceedings cannot also be transferred to the company court. It also stated that company court cannot use its powers under Sections 442 of the Companies Act 1956 against the Tribunal/Recovery Officer. Court held that the purpose of the Act is more important than the purpose of sections 442, 446 and 537 of the Companies Act.

19.3.2 Procedure of Tribunals

Section 19 onwards prescribes the procedure of the Tribunal. Section 19 provides that any bank or financial institution which has to recover any debt from any person will make an application to the Tribunal, within the local limits of whose jurisdiction the defendant voluntarily resides or carries on business or personally works for gain or where the cause of

action wholly or in part arises. The application has to be in the prescribed form and supported by documents or other evidences. Once the Tribunal receives the application, it will issue summons and ask the defendant to show-cause within thirty days of the service of summons as to why the relief should not be granted. The defendant has to present a written statement of his defence. If the defendant claims a set-off then the defendant has to present a written statement containing the particulars of the debt sought to be set-off. The Tribunal has the authority to pass a final order both of the original claim and of the set-off. The defendant has the right to set up a counter-claim. Tribunal has power to pass an interim order restraining the defendant from transferring, alienating or otherwise disposing off any property or asset belonging to him without the permission of the tribunal. Tribunal can also direct the defendant to furnish security. In case of failure of defendant to furnish security, Tribunal can order attachment of property sufficient to satisfy any certificate for recovery of debt. Tribunal also has the power to appoint a receiver of any property, remove any person from the possession or custody of the property, commit property to the possession, custody or management of the receiver, confer upon the receiver all powers necessary for bringing and defending suits and appoint Commissioner for preparing inventory of properties of the defendant or its sale. Section 19 provides that in case a certificate of recovery is issued against a company, Tribunal can order that the sale proceeds of the company should be distributed among its secured creditors. In case Tribunal issues a certificate of recovery for satisfaction of which the property is located within the local jurisdiction of some other Tribunal, the Tribunal can send the copy of the certificate of recovery for execution to the other Tribunal within whose jurisdiction the property is situated. Endeavour should be made to dispose of application within one hundred and eighty days from the date of receipt of application. Provision for appeal is made under section 20. No appeal lies from an order passed by the consent of the parties. Appeal should be filed within forty-five days of receipt of the order. An appeal should be disposed of within six months from the date of receipt of appeal. Section 21 provides that in case an appeal is preferred by any person from whom an amount of debt is due to a bank or a financial institution, appeal will not be entertained unless seventy-five percent of the amount of debt due is deposited.

Section 22 provides for the procedure to be followed by the Tribunal and the Appellate Tribunal. It provides that both the Tribunal and the Appellate Tribunal are not bound by the procedure laid down by the Code of Civil Procedure 1908. The Tribunals are guided by the principle of natural justice and have the power to regulate their own proceedings. The Tribunal and the Appellate Tribunal have the same powers as are vested in

a civil court for summoning and enforcing the attendance of any person and examining him on oath; requiring the discovery and production of documents; receiving evidence on affidavits; issuing commissions for the examination of witnesses or documents; reviewing its decisions; dismissing an application for default or deciding it *ex parte*; setting aside any order of dismissal of any application for default or any order passed by it *ex parte*; any other matter which may be prescribed. Proceedings before the Tribunal or the Appellate Tribunal are deemed to be judicial proceeding. Thus both the bank or financial institution and the defendant have the right to legal representation under Section 23.

19.3.3 Recovery of Debts Determined by Tribunal and Miscellaneous Provisions

Chapter V of the Act provides for the recovery of debts determined by the Tribunals. Section 25 of the Act provides for three different modes of recovery of debt. These are - (a) Attachment and sale of the movable or immovable property of the defendant; (b) Arrest of the defendant and his detention in prison; (c) Appointing a receiver for the management of the movable or immovable properties of the defendant.

Section 26 provides that the validity of the amount mentioned in the certificate cannot be disputed by the defendant before the recovery officer. However, the Presiding Officer can grant time for payment of the amount due and in such cases, the Recovery Officer shall stay the proceedings until the expiry of the time granted. Section 28 provides for few other modes of recovery like if any amount is due from any person to the defendant then the Recovery Officer can require the person to deduct the amount due from the defendant under this Act and the amount deducted will be credited to the Recovery Officer. The Recovery Officer will grant a receipt for any amount paid and the person paying will be discharged from his liability to the defendant to the extent of the amount paid. If such person fails to make payment, he shall be deemed to be a defendant in default in respect of the amount specified and proceedings can be initiated against him for realization of the amount as if it was a debt due from him. Appeal against the order of recovery officer can be preferred under Section 30 of the Act. The appeal has to be made to the Tribunal and the Tribunal after hearing the appellant can confirm, modify or set aside the order made by the Recovery officer.

19.4 THE BANKER'S BOOK EVIDENCE ACT 1891

The Act was passed in the year 1891 and is applicable to the whole of India except the State of Jammu and Kashmir to amend the Law of Evidence with respect to 'Banker's Book'. The Act was necessary because in case of litigation involving banks, banks had to produce their books in evidence in the court. The Act defines 'Bankers Book' to include ledgers, day-

books, cash-books, account-books and all other books used in the ordinary business of bank whether kept in the written form or as printouts of data stored in a floppy disc, tape or any other form of electro-magnetic data storage device. Another important definition is "Certified copy" which means copy of any entry in the books of a bank along with a certificate written at the bottom of such copy that it is a true copy of such entry and the entry is contained in one of the ordinary books of the bank and was made in the ordinary and usual course of business. The certificate should be dated and subscribed by the principal accountant or manager of the bank with his name and title. It also consists of printouts of data stored in a floppy, disc, tape or any other electro-magnetic data storage device along with a certificate that it is a printout of such entry or a copy of such printout by the principal accountant or branch manager and a certificate by a person-in-charge of computer system containing description of the computer system, safeguards available to retrieve data lost, safeguards adopted to prevent unauthorized change of data, manner in which data is transferred from the system to removable media etc. Section 4 provides that a certified copy of any entry in a banker's book shall be prima facie evidence of the existence of such entry in all legal proceedings. Such certified copy will be admitted as evidence. Section 6 provides that the court can order any party to a legal proceeding to inspect and take copy of any entries in a Banker's book for the purpose of the proceeding.

In *Chandradhar Goswami* v. *The Gauhati Bank Ltd.* [AIR 1977 SC 1058], Court was to decide upon the validity of entry in bank's book of account. It held that a person cannot be held liable only on the basis of entries in books off account. It is immaterial whether such books of account are kept in the regular course of business. In cases other than where the person sought to be made liable accepts the correctness of the entries in the books of account, additional evidence is required. Copies presented under Section 4 of the Bankers' Book Evidence Act are insufficient to make a person liable.

19.5 SUMMARY

The aim of Banking Ombudsman Scheme is to facilitate resolution of complaints relating to certain services offered by banks. The scheme has been introduced since 1995 under Section 35A of the Banking Regulation Act 1949. The purpose of the scheme is to provide a forum wherein bank customers can bring up their complaints against certain services rendered by banks. For this purpose, a Banking Ombudsman is appointed who is generally a senior officer entrusted with the task of looking into complaints of deficiency in services. Around 15 Banking Ombudsmen have been appointed so far. The scheme covers all the Scheduled Commercial banks, Regional Rural banks and Scheduled Primary Co-

operative banks. The various services against which complaints can be brought have been specified under the scheme. A complaint can be filed by writing on a plain paper. It can also be field online. There is no fixed format and convenience of the consumer has been kept in mind by keeping the procedure very flexible. To file a complaint, one has to locate the Banking Ombudsman under whose jurisdiction the bank branch against whom complaint is sought to be made located. In case of services which are provided on a centralised basis, complaints can be made before the Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located.

The Ombudsman tries to settle the dispute by conciliation, mediation or settlement. In case the parties are able to arrive at a settlement, the Ombudsman passes an order to that effect and the terms of the settlement become binding on the bank and the complainant. In case the parties are not able to reach an agreement, the Ombudsman after hearing both the parties can pass an award. This award is voluntary in nature and the complainant can accept the award in full or reject it. If the complainant chooses to reject the award, the complainant can approach the Appellate Authority.

Recovery of Debts Due to Banks and Financial Institutions Act 1993 was passed to help banks and other financial institutions in recovering loans and enforcing securities charged with loans. The Act was passed on the recommendations of a committee set up in 1981 to suggest measures to overcome the problems faced by banks and other financial institutions. The Act provides for establishment of Tribunals and Appellate Tribunals by the Central Government. Such Tribunals are to be known as Debt Recovery Tribunals and exercise all the powers conferred on them under the Act. The jurisdiction of these Tribunals is decided by notification by the Central Government. Section 17 of the Act provides for the jurisdiction and the powers of the Tribunal. It provides that the Tribunal has the jurisdiction and the power to entertain applications from banks and financial institutions for recovery of debts due to such banks and financial institutions. The Appellate Tribunal has the jurisdiction and the power to entertain any appeal from the order made by a Tribunal. Chapter V of the Act provides for the recovery of debts determined by the Tribunals. Section 25 of the Act provides for the different modes of recovery of debt.

The Bankers Book Evidence Act 1891 was passed as in case of litigation involving banks, banks had to produce their books in evidence in the court. Section 4 provides that a certified copy of any entry in a banker’s book shall be prima facie evidence of the existence of such entry in all legal proceedings. Section 6 provides that the court can order any party to

a legal proceeding to inspect and take copy of any entries in a Banker's book for the purpose of the proceeding.

19.6 KEY WORDS

1. Recovery of Debts
2. Tribunal
3. Procedure
4. Bankers Book Evidence Act
5. Appellate Tribunal
6. Delay
7. Non-acceptance
8. Non-observance
9. Non-adherence
10. Jurisdiction

19.7 SELF ASSESSMENT QUESTIONS

1. What are the aims and objectives of Banking Ombudsman Scheme?

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2. Enlist the grounds of complaint under the Banking Ombudsman Scheme.

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3. What are the grounds on which complaint under Banking Ombudsman Scheme can be rejected?

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4. Discuss the procedure for filing complaint and procedure to be followed after receipt of complaint under Banking Ombudsman Scheme.

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5. Mention the jurisdiction and power of the Tribunals set up under the Recovery of Debts Due to Banks and Financial Institutions Act 1993. What is the procedure followed by said Tribunals established under the Act.

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6. Elaborate upon the objective behind enactment of Bankers Book Evidence Act 1891.

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UNIT-20: THE MODERN ASPECTS OF BANKING

Structure:

20.0 Objectives

20.1 Introduction

20.2 Changing role of banks

20.3 New methods of banking

20.4 Money laundering

20.5 Electronic fund transfer

20.6 Capital account convertibility

20.7 Net banking frauds

20.8 Prevention of economic offences cell of CBI

20.9 Guidance note on operational risk management

20.10 Information technology act 2000

20.11 Summary

20.12 Key words

20.13 Self Assessment Questions

20.14 References

20.0 OBJECTIVES

- To know the changing role of banks and the new methods of banking such as net banking, telephone banking, credit cards, debit cards, smart cards, ATMs and international cards.
- To understand the new offences coming up as a result of changing nature of banking.
- To analysing the Information Technology Act 2000 and its application to banking sector.

20.1 INTRODUCTION

While the core of banking business has remained the same, modern banking has evolved and a number of new trends have come up. Most of these new trends have come up with the growth and availability of new technologies, which were earlier unknown. Banking business has underwent transformation and new services such as Internet banking, telephone banking, credit cards, debit cards, smart cards, loans against shares in DEMAT format etc are available now. This new trend has helped in simplifying the banking facilities to the customers, catering to the manifold needs of the public in general.

20.2 CHANGING ROLE OF BANKS

The traditional banking business has undergone sea change and today banks have a much larger role to play. With technology the way in which banking business was previously conducted has changed. As discussed before, one of the major sources of earning of banks is via lending loans. As per the new developments banks are able to advance loans even against shares in DEMAT format. As per Reserve Bank guidelines, the maximum amount of loan which can be granted against DEMAT shares is ₹ 20 Lakh. The shares in DEMAT form should be fully paid and usually banks insist upon guarantee in case of such loans.

Also another new concept that has come up is corporate banking which includes the different banking and financial services provided to corporate entities. These include making available different banking products, term loans, letter of guarantee, external commercial borrowings, overdraft facility, channel financing, payment (domestic and international), advisory services on investment, asset management (financial services are provided by the bank wherein the bank invests on behalf of its clients), different personalized financial solutions to corporate etc.

20.3 NEW METHODS OF BANKING

Net Banking:

Online banking or net banking refers to using a bank's services on a website operated by the bank. Online services are increasingly becoming popular due to the convenience offered by them doing away with the need to physically go to a bank for the same service. For this purpose, it is necessary to have a User ID and a password. Both these are provided by the bank itself, usually at the time of account opening. At the same time, all the transaction alerts are sent to the registered mobile number of the user, creating a double security system to prevent any misuse.

A long list of services is available online in this modern era of Internet. First, one of the most prominent uses of Internet banking is the transfer of funds between different bank accounts belonging to same bank or different banks. While the former is done free of cost by many banks, the latter is subject to a very nominal charge. Second, the debit/credit cards issued by the banks are useful for online shopping, which is becoming more or less a common feature in the recent past. Third, online payment facility can be used for payment of various bills such as telephone bills, electricity bills, water bills, insurance premiums etc. A mobile phone can also be recharged online. Fourth, the taxes can be paid using Internet banking services. Finally, account balance and details of transactions can be checked online. Periodic account statements can also be generated.

Telephone Banking:

The reach of mobile phones has increased tremendously in the recent past and there are more than 600 million wireless telephone subscribers in India. Telecommunication boom has lead to faster, cheaper and increased communication. Banks too are taking advantage of this new development and are providing services via phone. This has largely been heralded by Reserve Bank which has propagated the Bank-Led model of mobile banking. Recognizing the role of mobile service providers (MSPs), Reserve Bank has enabled these MSPs to be appointed as business correspondents of banks. In this regard, a number of steps have been taken since 2008 wherein there has been increased liberalization of the manner and extent in which banks can go for mobile banking. Facilities which are possible via mobile phones include transfer of funds between bank accounts, money transfer from a bank account with cash pay-out at an ATM, message alerts for all card transactions etc. Reserve Bank has launched the Inter Bank Mobile payment System (IMPS) under which a centralized infrastructure for money transfer between customer accounts in different banks through

mobile phone is being operated. This service uses the National Financial Switch (NFS) interbank ATM transaction switching infrastructure. However, the facility of mobile banking can only be provided by banks which have received one-time approval from the Reserve Bank.

Credit Cards:

Credit basically means to borrow something from someone. A credit card is one which allows the holder of it to borrow money from the card issuer. Usually these cards are issued by banks and non-banking financial institutions. The card is a synthetic card made of laminated plastic sheet. It is useful for the customers in many ways. First, it is a viable option for short term borrowing of funds. Second, it also comes in handy as the holder of the card has an alternative to cash payment doing away with the necessity of carrying cash always. Third, credit cards are also very convenient for executing transactions via electronic means such as card sweeping machines or online payments.

Card comes with a credit limit, that is, the extent to which the holder can borrow from the issuer. This limit which is pre-communicated to the holder might vary from customer to customer and the bank or the issuer fixes this limit depending upon the creditworthiness of the holder. Creditworthiness is an indicator of the financial condition of the holder and is determined depending upon a number of factors. Credit limited is again divided into two main types – cash withdrawal limit and credit transaction limit. Cash withdrawal limit is the maximum amount of cash which can be withdrawn via a credit card. Credit transaction limit is the maximum limit on credit transactions which can be done via a credit card. Ideally, cash withdrawal limit will be less than the credit transaction limit.

The physical characteristics of a credit card such as its size, thickness etc., are determined by ISO/IEC 7810. This is an international standard where ISO is an abbreviation for International Organization for Standardization and IEC is an abbreviation of International Electrotechnical Commission. The ID-1 format of ISO/IEC 7810 with slight variations is followed globally. The front side of a credit card and its back side contain some vital information. Though this information cannot be generalized, we can expect these details to be present on a credit card. The information present on the front side of a credit card include cardholder's name, card number, date of issue, date of expiry, Individual account identifier number, Issuer identifier number (IIN), microchip (embedded), logo of issuing entity and payment processor and Bank Identification number (BIN). Back side of a credit card will usually have a magnetic strip, card verification number and a signature panel. The card issuer fixes a repayment date along with an applicable rate of interest. Usually the repayment date is

30-45 days after the date of credit borrowing or in the alternative the issuer can go for monthly billing. The failure to pay back the amount within the stipulated period would result in heavy interest being charged.

Debit Cards:

Debit cards are cards issued by banks to their customers to help them to access their account at any time. Debit cards are used by account holders to withdraw cash from their account or to pay various bills. It does away with the necessity of going to the bank for withdrawing cash or from carrying ready cash for bill payment. In contrast to the credit card, the debit card draws money from the account of the card-holder. As in case of the debit card, it is one's own money which is used by the card holder, such cards are easier to get. The bank runs a stringent check before issuing a credit card which is not the case with debit card. Also, with a debit card, one need not worry about paying interest on the money credited. The different advantages of a debit card are:

(a) Debit cards are easier to get in comparison to credit cards.

(b) It does away with the necessity of writing cheques or carrying cash for paying bills or making purchases.

(c) Payments made via debit card are vastly recognized in business community and there is no fear of dishonor.

(d) Debit card transactions via ATM are free unless done from a ATM of some other bank other than the card issuing bank

A number of banks provide facility of dual card wherein a card can be used both as debit and credit card. While transacting using such a card, the card holder gets an option to specify to use either the debit card or the credit card. The misuse of the debit and credit cards are prevented by personal identification number (PIN), passwords and the verification of signature of the customer in the backside of the cards. While the PIN protects from fraud in cash withdrawal, the passwords and signature verification protect the fraud in online payments.

ATMs

ATM stands for Automated Teller Machine whose primary function is to allow users to withdraw cash without going to a bank. For this purpose, a 4 digit number is required (PIN) which has to be entered for using the ATM or debit card. ATM gives the user the facility to withdraw cash at any time, irrespective of the bank's timing. Further, withdrawal of money at ATMs is faster as there is no need to stand in queues. Also, to withdraw money from ATM, there is no need to fill any withdrawal slip. ATMs also offer the convenience of

being located at multiple places. Usually, these ATMs are located near or inside the bank premises. These are also located in shopping malls or places where people go on regular basis in large numbers such as any tourist sites, restaurants, bus stations, railway stations, airports etc. ATMs may not be helpful in case the system is down or it runs out of cash. There is also the additional problem of forgetting the PIN number and a number of robbery cases have come up pertaining to ATMs. Usually use of ATM is free if card of the bank setting up the ATM is used. For use of card of other banks an additional fees can be charged. Most of the ATMs are connected to interbank networks which allow people to withdraw money from ATMs of other bank. The primary purpose of ATMs is allowing users to withdraw cash. However, nowadays most of the ATMs make available other services such as bill payment, printing bank statement, purchasing of different types of tickets and even crediting money to bank accounts.

Smart Card:

A smart card is a pocket sized card with integrated circuits embedded in it. These cards can be used for a variety of purposes. Due to their ability to save large quantity of data, they can be used for data storage, processing application and also as identity cards. Smart cards are similar to credit cards in terms of physical features. Inside it is an embedded microprocessor. Smart cards are superior to credit or debit cards as the information stored in the magnetic strip can be tampered with easily. In contrast, smart cards contain embedded microprocessors which contain vital information. Due to their enhanced features, smart cards are used as credit cards and various other applications in the banking sector.

International Cards:

International Cards or International Debit Cards are similar to the standard debit cards with the sole difference that these cards can be used regardless of territory. These cards allow the holder to pay domestic charges on purchases in foreign country, saving on payment of fees on international transactions. In case of International debit card, the holder saves on the charges of currency conversion and only a one- time fee of transferring money to the card is charged. The transfer of money can be done from anywhere in the world. Other than this one time charge, the holder pays domestic charges on all his subsequent transactions. These cards have a PIN Number, which ensures security of the card in case the card gets lost.

20.4 MONEY LAUNDERING

Money laundering is a very serious economic offence which involves converting money obtained from illegal sources into white money, creating the impression of having

originated from legitimate sources. Section 3 of the Prevention of Money Laundering Act 2002 defines money laundering as “Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering”. ‘Proceeds of crime’ has been defined as “any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property”. Section 12 of the Prevention of Money Laundering Act 2002 provides that every banking company, financial institution and intermediary should maintain a record of transactions undertaken by them. The records that are to be maintained include-

(a) Cash transactions of value more than 10 lakhs or its equivalent in foreign currency.

(b) Integrally connected cash transactions taking place within a month.

(c) Cash transactions were forged or counterfeit notes are involved.

(d) Suspicious transactions.

These records should be maintained for a period of 10 years from the date of transaction.

Rule 8 of the Prevention of Money Laundering Rules 2005 provides for the transactions which have to be reported to the Director. These include, first, transactions of 10 lakhs and more and integrally connected transactions taking place within a month. Information about such transactions has to be submitted every month before the 15th day of the succeeding month. Second, **i**nformation relating to forged or counterfeit notes should be submitted to the Director within seven days of the date of occurrence of the transaction. Third, information about suspicious transactions is to be submitted to the Director within a period of seven working days on being satisfied that the transaction is suspicious. Under Section 13 of Prevention of Money Laundering Act, Director can impose a fine of not less than 10 thousand rupees which may extend to 10 lakh for failure to report. Penal provisions are also contained under Section 63 and 70 of the Act.

Basel Committee on Banking Supervision has come up with a number of suggestions to deal with money laundering. These include:

(a) Strict due diligence.

(b) Promotion of better understanding about inherent money laundering.

(c) Promotion of sound ML/FL risk management techniques.

(d) Proper verification of identity of customers and persons acting on behalf of customers.

20.5 ELECTRONIC FUND TRANSFER

Electronic fund transfer is the transfer of money from one account to another via online mode. The transfer can be in a single bank or could involve different financial institutions. We have two electronic fund transfer system - Real Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT). The RTGS is maintained by the Reserve Bank. In this, the transfer of money takes place on 'real time' and on 'gross basis'. Therefore, there is no waiting period for transfer, which takes place immediately. For RTGS both remitting and receiving banks should have core banking services in place. In addition, Indian Financial System Code (IFSC) is required for making the RTGS transactions. IFSC is a unique code, which is different for each branch of the banks. Payments made under RTGS are final.

Under NEFT, individuals, firms and corporate can transfer money from one bank branch to another electronically. The bank branches have to be NEFT-enabled to carryon such transactions. Just like NEFT, IFSC is required for making transactions. Both the above systems are for one to one transfers, that is, transfer from one person or entity to another person or entity. In case of bulk transfer, which requires the fund transfer from one person or entity to multiple persons or entities, Electronic Clearing Service (ECS) is used. This is useful for the distribution of the pension, dividend, interest or salary, among others. In addition, the ECS facility may also be used in the payment of electricity bills, telephone charges, insurance premiums etc. by directing the banks to transfer the required amount periodically. Depending on the uses mentioned above, ECS can be ECS Credit (crediting pension, dividend, interest, salary etc) or ECS Debit (debiting the electricity/telephone/water charges, insurance premiums etc).

20.6 CAPITAL ACCOUNT CONVERTIBILITY

Capital account convertibility is the ability to conduct transactions of local financial assets into foreign financial assets. In case of full, capital account convertibility, local currency can be freely exchanged for foreign currency without any restriction. The Reserve Bank of India has set up the Tarapore Committee in 1997 to examine various aspects of capital account convertibility. The committee defined the same as the freedom to convert financial assets into foreign financial assets and vice versa at market determined rates of exchange. India established current account convertibility under its obligations under Article VIII of IMF's Article of Agreement. Article VIII deals with 'General Obligations of Members'. Tarapore committee had laid down a three year road map for it. Capital account convertibility helps foreign investors in making a quick exit from any market if they want to

as they are able to re-convert local currency into foreign currency without any restrictions. While this has the effect of attracting investments, this can also lead to destabilizing of the financial set up of a country if there are huge and sudden inflows and outflows.

20.7 NET BANKING FRAUDS

Reserve Bank has taken a number of steps to deal with increasing incidents of net banking frauds. Reserve Bank from time to time has issued a number of directions to be adopted by banks to deal with the problem. They primarily call for strict monitoring of the number of beneficiaries a customer can add for fund transfer from his bank account and limitation of such addition. In addition, banks are advised to switch to chip and pin based credit cards which ask for additional pin based authentication. At present, Reserve Bank is in the process of working on framing of broad guidelines to check the problem. There have been increasing incidences of frauds via the online mode with most of the frauds originating outside the country, making it difficult to effectively deal with it.

20.8 PREVENTION OF ECONOMIC OFFENCES CELL OF CBI

Economic Offence Wing in CBI was created in 1964. The offences which can be dealt with by the Economic Wing include offences under various Sections of IPC and Special Acts notified under Section 3 of the Delhi Special Police Establishment Act 1946. These include-

(a) Frauds in Banks, Stock Exchanges, Financial Institutions, Joint Stock Companies, Public Limited Companies.

(b) Misappropriation of public funds.

(c) Criminal breach of trust.

(d) Violation of Foreign Exchange Regulation Act.

(e) Violation of Customs Act.

(f) Violation of IMPEX laws.

(g) Counterfeiting of currency.

(h) Narcotics

(i) Drug Trafficking.

(j) Arms Peddling.

(k) Offences of adulteration, black marketing etc.

The Economic Offences Division has four Zones. One Zone (Banking Securities Fraud Cell) deals exclusively with case of bank frauds. Other three Zones deal with investigation of other economic offences. Economic Intelligence Cell (EIC) established under Economic offence Wing, Delhi Region, is entrusted with collection of intelligence on

economic crimes. Economic Offences Division has to work in close coordination with Ministries of Finance, Commerce, Department of Revenue, Banking, CEIB, SEBI and other Central/State level economic institutions.

20.9 GUIDANCE NOTE ON OPERATIONAL RISK MANAGEMENT

Basel Committee on Banking Supervision, in its "Consultative Document on Operational Risk", defines "operational risk" as the risk of direct, or indirect, loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk management (identification and management of risk) is an integral part of risk management activity undertaken by banks. Operation risk management aims at prevention of fraud, maintaining sound internal controls, and reduction in transaction processing errors.

This involves –

(a) Listing down of liabilities of Board of Directors for providing a sound internal control system.

(b) Promotion of Operation risk management in entire bank.

(c) Putting responsibility of Operation risk management upon the senior management.

(d) Promoting awareness of Operating risks especially among bank officials.

20.10 INFORMATION TECHNOLOGY ACT 2000

Introduction:

Information Technology Act 2000 was enacted in the year 2000 "to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as 'electronic commerce', which involve the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the Government agencies and further to amend the Indian Penal Code, the Indian Evidence Act 1872, the Bankers' Books Evidence Act 1891 and the Reserve Bank of India Act 1934 and for matters connected therewith or incidental thereto."[6] The Act which came into force from 17 October 2000 was amended in the year 2008 to plug its loopholes. 2008 amendment laid down specific guidelines to cover menace of data privacy. Cyber café was defined and digital signature was made technology neutral. At the same time recognition was given to Indian Computer Emergency Response Team, cyber crimes such as child pornography and cyber terrorism. As

[6] Preface to the Act.

per the IT Act, its provisions are applicable to negotiable instrument (Other than a cheque) as defined in section 13 of the Negotiable Instruments Act 1881.

Penal Provisions:

Section 43, which has been amended vide Information Technology Amendment Act 2008, provides for penalty and compensation for damage to computer, computer system, etc. As per the section, liability of payment of damages by way of compensation not exceeding one crore rupees to the person so affected is imposed upon any person who without permission of the owner or any other person who is in-charge of a computer, computer system or computer network -

(a) Accesses or secures access to such computer, computer system or computer network or computer resource;

(b) Downloads, copies or extracts any data, computer data base or information from such computer, computer system or computer network including information or data held or stored in any removable storage medium;

(c) Introduces or causes to be introduced any computer contaminant or computer virus into any computer, computer system or computer network;

(d) Damages or causes to be damaged any computer, computer system or computer network, data, computer data base or any other programmes residing in such computer, computer system or computer network;

(e) Disrupts or causes disruption of any computer, computer system or computer network;

(f) Denies or causes the denial of access to any person authorised to access any computer, computer system or computer network by any means;

(g) Provides any assistance to any person to facilitate access to a computer, computer system or computer network in contravention of the provisions of this Act, rules or regulations made there under,

(h) Charges the services availed of by a person to the account of another person by tampering with or manipulating any computer, computer system, or computer network,

(i) Destroys, deletes or alters any information residing in a computer resource or diminishes its value or utility or affects it injuriously by any means;

(i) Steals, conceals, destroys or alters or causes any person to steal, conceal, destroy or alter any computer source code used for a computer resource with an intention to cause damage.

Section 43A provides norms relating to compensation for failure to protect data. It provides that in case any corporate body possessing, dealing or handling any sensitive personal data or

information in a computer resource which it owns, controls or operates, is negligent in implementing and maintaining reasonable security practices and procedures and thereby causes wrongful loss or wrongful gain to any person, such body corporate shall be liable to pay damages by way of compensation, not exceeding five crore rupees, to the person so affected.

Section 65 onwards provides for various cyber offences. Section 65 deals with tampering with computer source documents. The offence is made punishable with imprisonment up to three years, or with fine which may extend up to two lakh rupees, or with both. Section 66 provides for computer related offences. As per section 66, if any person, dishonestly, or fraudulently, does any act referred to in section 43, he shall be punishable with imprisonment for a term which may extend to three years or with fine which may extend to five lakh rupees or with both. Section 66A provides punishment for sending offensive messages through communication service. As per Section 66A, imprisonment for a term of two years and fine is provided for any person who sends, by means of a computer resource or a communication device -

a) Any information that is grossly offensive or has menacing character; or
b) Any information which he knows to be false, but for the purpose of causing annoyance, inconvenience, danger, obstruction, insult, injury, criminal intimidation, enmity, hatred, or ill will, persistently makes by making use of such computer resource or a communication device,
c) Any electronic mail or electronic mail message for the purpose of causing annoyance or inconvenience or to deceive or to mislead the addressee or recipient about the origin of such messages.

Section 66 B prescribes punishment for dishonestly receiving stolen computer resource or communication device. Any person dishonestly receiving or retaining any stolen computer resource or communication device can be punished with imprisonment of either description for a term which may extend to three years or with fine which may extend to rupees one lakh or with both. Section 66C deals with punishment for identify theft. Any person whoever, fraudulently or dishonestly makes use of electronic signature, password or any other unique identification feature of any other person, shall be punished with imprisonment of either description for a term which may extend to three years and shall also be liable to fine which may extend to rupees one lakh. Further, Section 66D provides that cheating by personation by using computer resource can be punished with imprisonment of either description for a term which may extend to three years and shall also be liable to fine

which may extend to one lakh rupees. Section 66E makes violation of privacy punishable with imprisonment, which may extend to three years or with fine not exceeding two lakh rupees, or with both. Intermediaries have been exempted from liability for any third party information, data, or communication link hosted by him under Section 79. For claiming exemption, function of the intermediary should be limited to providing access to a communication system over which information made available by third parties is transmitted or temporarily stored. Intermediaries are also entitled to exemption if the intermediary does not- (i) initiate the transmission, (ii) select the receiver of the transmission, and (iii) select or modify the information contained in the transmission. Intermediaries are expected to observe due diligence while discharging their duties and also observe such other guidelines as may be prescribed by Central Government. Intermediaries cannot claim exemption in case-

(a) The intermediary has conspired or abetted or aided or induced whether by threats or promise or otherwise in the commission of the unlawful act.

(b) Upon receiving actual knowledge, or on being notified that any information, data or communication link residing in or connected to a computer resource controlled by the intermediary is being used to commit the unlawful act, intermediary fails to expeditiously remove or disable access to that material on that resource without vitiating evidence in any manner.

Section 46 provides that the Central Government can appoint any officer not below the rank of a Director to the Government of India or an equivalent officer of a State Government to be an adjudicating officer for holding an inquiry in the manner prescribed by the Central Government. Section 47 details the factors to be taken into account by adjudicating officer while adjudging the quantum of compensation. The factors to be taken into consideration include-

(a) The amount of gain of unfair advantage, wherever quantifiable, made as a result of the default;

(b) The amount of loss caused to any person as a result of the default;

(c) The repetitive nature of the default.

For the purpose of adjudication of disputes, section 48 provides for establishment of Cyber Appellate Tribunal. The matters and places in relation to which the Cyber Appellate Tribunal may exercise jurisdiction are specified by Central Government. Appeal from any decision or order of Cyber Appellate Tribunal lies to High Court. Such an appeal under Section 62 has to be filed within sixty days from the date of communication of the decision or order of the Cyber Appellate Tribunal.

20.11 SUMMARY

While the core of banking business has remained the same, modern banking has evolved and a number of new trends have come up. Most of these new trends have come up with the growth and availability of new technologies that were earlier unknown. Banking business has been transformed and new services such as internet banking, telephone banking, credit cards, debit cards, smart cards, availability of loans against shares in DEMAT format etc are available now. Use of information technology in the banking sector has also triggered the growth of new offences making it necessary to come up with appropriate legal regime to check it. Reserve Bank has taken a number of steps to deal with increasing incidents of net banking frauds. Reserve Bank from time to time has issued a number of directions to be adopted by banks to deal with the problem. Economic Offence Wing in CBI was created in 1964. The Economic Offences Division has four Zones. One Zone (Banking Securities Fraud Cell) deals exclusively with case of bank frauds. Other three Zones deal with investigation of other economic offences. Economic Intelligence Cell (EIC) established under Economic offence Wing, Delhi Region is entrusted with collection of intelligence on economic crimes. Economic Offences Division has to work in close coordination with Ministries of Finance, Commerce, Department of Revenue, Banking, CEIB, SEBI and other Central/State level economic institutions.

Money laundering is a very serious economic offence, which involves converting money obtained from illegal sources into white money, creating the impression of having originated from legitimate sources. Basel Committee on Banking Supervision has come up with a number of suggestions to deal with money laundering. Electronic fund transfer is the transfer of money from one account to another via online mode. The transfer can be in a single bank or could involve different financial institutions. We have two electronic fund transfer system - (i) Real Time Gross Settlement (RTGS) and (ii) National Electronic Funds Transfer (NEFT) systems. Both these systems are for one to one transfers. In case of bulk transfer, Electronic Clearing Service (ECS) is used.

Capital account convertibility is the ability to conduct transactions of local financial assets into foreign financial assets. In case of full, capital account convertibility, local currency can be freely exchanged for foreign currency without any restriction. Information Technology Act 2000 was enacted in the year 2000 “to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as ‘electronic commerce’, which involve the use of

alternatives to paper-based methods of communication and storage of information..." The Act provides for punishment for damaging computer, computer system etc, tampering with computer source documents, sending offensive messages, dishonestly receiving stolen computer resource or communication device and other computer related offences.

20.12 KEY WORDS

1. Role of Bank
2. Net banking
3. Telephone banking
4. Credit Cards
5. Debit Cards
6. Smart Cards
7. International Cards
8. ATMS
9. Money laundering
10. Electronic Fund Transfer
11. Capital Account Convertibility
12. Prevention of Economic Offences Cell
13. Operational Risk management
14. Information Technology Act 2000
15. Computer
16. Computer system
17. Data
18. Intermediary
19. Cyber Appellate Tribunal

20.13 SELF ASSESSMENT QUESTIONS

1. How has the traditional role of banks changed?

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   ....

2. Write a short notes on the followings.

   (a) Net Banking

   (b) Telephone banking

   (c) Credit Cards

   (d) Debit Cards

(e) Smart Cards

(f) International Cards

(g) ATMS.

(h) Capital Account Convertibility

3. What is money laundering? Discuss the relevant provisions contained in the prevention of Money Laundering Act 2002.

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4. What is Electronic Fund Transfer? Mention the broad guidelines framed by Reserve Bank to deal with net banking frauds.

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5. What are the various offences which can be dealt with by the economic Offence Wing of CBI?

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6. How does the Information Technology Act 2000 address the problems associated with the electronic transactions.

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