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FAIRFIELD
Institute of Management & Technology
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B.B.A (B & I)

GURU GOBIND SINGH INDRAPRASTHA UNIVERSITY

B.B.A (B & I): 301 Banking Law and Practice

L-4 T/P-0 Credits-4

INSTRUCTIONS TO PAPER SETTERS MAXIMUM MARKS: 75

Question no. 1 should be compulsory and cover the entire syllabus. The question should have objective or short answer type questions. It should be of 15 marks.

Every unit should have two questions. Students may be asked to attempt only 1 question from each unit. Each question should be of 15 marks.

Note: Students are expected to have elementary knowledge of the topics specified in the syllabus

Objectives: The course aims to acquaint the student with a basic and elementary knowledge of the business and corporate laws.

Course Contents

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Overview, Legal Framework of Regulation of Banks, Reserve Bank of India Act1930

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Banking Regulation Act, 1949, Negotiable Instruments Act 1860

Unit III Lectures: 14

Cyber Laws Relating to Banking, Banking Companies Act, 1970/ 1980; Information Techology

Act (2000) and its Relevance to Banking.

Unit IV Lectures: 12

Securitization Act, (2002)., Recent Trends in Banking Industry (Legal)

Text Books

1. Varshney P.N., (2006), *Banking Law and Practice*; Sultan Chand and Sons.

2. Saxena G.S., (2008), L*egal Aspects of Banking Operations,* Sultan Chand and Sons.

Reference Books:

1. Suneja H.R., (2007), P*ractical and Law of Banking,* Himalya Publishing House.

2. Chabra T.N, (2008), *Elements of Banking Law,* Dhanpat Rai and Sons.

Unit I

- **Overview**
- **Legal Framework of Regulation of Banks,**
- **Reserve Bank of India Act1930**

OVERVIEW OF BANKING LAW: What is banking law?

Banking law is not a discrete area of law like contract or torts. It conveniently describes the collection of legal principles which impact on banking transactions and on the banker-customer relationship. In that sense, the activity of banking is the location at which a diverse range of legal principles intersect which we call banking law.

Those legal principles are drawn from a range of sources, including common law, the Law Merchant, 1 equity and statute.

In addition, for banks that subscribe to it, the Code of Banking Practice is a legally enforceable set of legal formalities which is required to be undertaken by every bank as the Code of Banking Practice which is legally enforceable set of principles and rules incorporated into the contract between the bank and its retail customers.

Relevant legislation includes:

• Banking Act 1959 (Cth)

• Reserve Bank Act 1959 (Cth)

• Australian Prudential Regulation Authority Act 1998 (Cth)

• Australian Securities and Investments Commission Act 2001 (Cth), which contains in Division 2 the unconscionable conduct and consumer protection provisions in relation to financial services providers that are no longer in the Trade Practices Act

• Corporations Act 2001 (Cth), in particular Pt 7

• Privacy Act 1988 (Cth), in particular the credit information provisions in Part IIIA

• Consumer Credit Code, usually referred to as the Uniform Consumer Credit Code

• Cheques Act 1986 (Cth)

• State Fair Trading Acts, e.g. Fair Trading Act 1999 (Vic)

Evolution of Banking and Banks (HISTORY AND GROWTH OF BANKING) & LEGAL FRAMEWORK OF REGULATION OF BANKS

Banks have existed since the founding of the United States, and their operation has been shaped and refined by major events in U.S. history. Banking was a rocky and fickle enterprise, with periods of economic fortune and peril, between the 1830s and the early twentieth century. In the late nineteenth century, the restrained money policies of the U.S. Treasury Department, namely an unwillingness to issue more bank notes to eastern-based national banks, contributed to a scarcity of cash in many Midwestern states. A few states went so far as to charter local banks and authorize them to print their own money. The collateral or capital that backed these local banks was often of only nominal value. By the 1890s, there was a full-fledged bank panic. Depositors rushed to banks to withdraw their money, only to find in many cases that the banks did not have the money on hand. This experience prompted insurance reforms that developed during the next fifty years. The lack of a regulated money supply led to the passage of the Federal Reserve Act in 1913 (found in scattered sections of 12 U.S.C.A.), creating the Federal Reserve Bank System.

Even as the banks sometimes suffered, there were stories of economic gain and wealth made through their operation. Industrial enterprises were sweeping the country, and their need for financing was seized upon by men like J.P. Morgan (1837–1913). Morgan made his fortune as a banker and financier of various projects. His House of Morgan was one of the most powerful financial institutions in the world. Morgan's holdings and interests included railroads, coal, steel, and steamships. His involvement in what we now consider commercial banking and Securities would later raise concern over the appropriateness of mixing these two industries, especially after the Stock Market crash of 1929 and the ensuing instability in banking. Between 1929 and 1933, thousands of banks failed. By 1933, President FRANKLIN D. ROOSEVELT temporarily closed all U.S. banks because of a widespread lack of confidence in the institutions. These events played a major role in the Great Depression and in the future reform of banking.

In 1933, Congress held hearings on the commingling of the banking and securities industries. Out of these hearings, a reform act that strictly separated commercial banking from securities banking was created (12U.S.C.A. §§ 347a, 347b, 412). The act became known as the Glass-Steagall Act, after the two senators who sponsored it, Carter Glass (DVA) and Henry B. Steagall (D-AL). The Glass-Steagall Act also created the Federal Deposit Insurance Corporation (FDIC), which insures money deposited at member banks against loss. Since its passage, Glass-Steagall has been the law of the land, with minor fine-tuning on several occasions.

Despite the Glass-Steagall reforms, periods of instability have continued to reappear in the banking industry. Between 1982 and 1987, about 600 banks failed in the United States. Over one-third of the closures occurred in Texas. Many of the failed banks closed permanently, with their customers' deposits compensated by the FDIC; others were taken over by the FDIC and reorganized and eventually reopened.

In 1999, Congress addressed many concerns on many involved in the financial industries with the passage of the Financial Services Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338, also known as the Gramm-Leach Act. The act rewrote the banking laws from the 1930s and 1950s, including the Glass-Steagall Act, which had prevented commercial banks, securities firms, and insurance companies from merging their businesses. Under the act, banks, brokers, and insurance companies are able to combine and share consumer transaction records as well as other sensitive records. The act went into effect on November 12, 2000, though several of its provisions did not take effect until July 1,2001. Seven federal agencies were responsible for rewriting regulations that implemented the new law.

Gramm-Leach goes beyond the repeal of the Glass-Steagall Act and similar laws. One section streamlines the supervision of banks. It directs the Federal Reserve Board to accept existing reports that a bank has filed with other federal and state regulators, thus reducing time and expenses for the bank. Moreover, the Federal Reserve Board may examine the insurance and brokerage subsidiaries of a bank only if reasonable cause exists to believe the subsidiary is engaged in activities posing a material risk to bank depositors. The new law contains many more similar provisions that restrict the ability of the Federal Reserve Board to regulate the new type of bank that the law contemplates. The Gramm-Leach Act also breaks down barriers of foreign banks wishing to operate in the United States by allowing foreign banks to purchase U.S. banks.

Categories of Banks

There are two main categories of banks: federally chartered national banks and state-chartered banks.

A national bank is incorporated and operates under the laws of the United States, subject to the approval and oversight of the comptroller of the currency, an office established as a part of the Treasury Department in 1863 by the National Bank Act (12 U.S.C.A. §§ 21, 24, 38, 105, 121, 141 note).

All national banks are required to become members of the Federal Reserve System. The Federal Reserve, established in 1913, is a central bank with 12 regional district banks in the United States. The Federal Reserve creates and implements national fiscal policies affecting nearly every facet of banking. The system assists in the transfer of funds, handles government deposits and debt issues, and regulates member banks to achieve uniform commercial procedure. The Federal Reserve regulates the availability and cost of credit, through the buying and selling of securities, mainly government bonds. It also issues Federal Reserve notes, which account for almost all the paper money in the United States.

A board of governors oversees the work of the Federal Reserve. This board was approved in 1935 and replaced the Federal Reserve Board. The seven-member board of governors is appointed to 14-year terms by the President of the United States with Senate approval.

Each district reserve bank has a board of directors with nine members. Three nonbankers and three bankers are elected to each board of directors by the member bank, and three directors are named by the Federal Reserve Board of Governors.

A member bank must keep a reserve (a specific amount of funds) deposited with one of the district reserve banks. The reserve bank then issues Federal Reserve notes to the member bank or credits its account. Both methods provide stability in meeting customers' needs in the member bank. One major benefit of belonging to the Federal Reserve System is that deposits in member banks are automatically insured by the FDIC. The FDIC protects each account in a member bank for up to $100,000 should the bank become insolvent.

A state-chartered bank is granted authority by the state in which it operates and is under the regulation of an appropriate state agency. Many state-chartered banks also choose to belong to the Federal Reserve System, thus ensuring coverage by the FDIC. Banks that are not members of the Federal Reserve System can still be protected by the FDIC if they can meet certain requirements and if they submit an application.

The Interstate Banking and Branching Efficiency Act of 1994 (scattered sections of 12U.S.C.A.) elevated banking from a regional enterprise to a more national pursuit. Previously, a nationally chartered bank had to obtain a charter and set up a separate institution in each state where it wished to do business; the 1994 legislation removed this requirement. Also, throughout the 1980s and the early 1990s, a number of states passed laws that allowed for reciprocal interstate banking. This trend resulted in a patchwork of regional compacts between various states, most heavily concentrated in the New England states.

Types of Banks

The term *bank* is generally used to refer to commercial banks; however, it can also be used to refer to savings institutions, savings and loan associations, and building and loan associations.

A commercial bank is authorized to receive demand deposits (payable on order) and time deposits (payable on a specific date), lend money, provide services for fiduciary funds, issue letters of credit, and accept and pay drafts. A commercial bank not only serves its depositors but also can offer installment loans, commercial long-term loans, and credit cards.

A savings bank does not offer as wide a range of services. Its primary goal is to serve its depositors through providing loans for purposes such as home improvement, mortgages, and education. By law, a savings bank can offer a higher interest rate to its depositors than can a commercial bank.

A Savings and Loan Association (S&L) is similar to a savings bank in offering savings accounts. It traditionally restricts the loans it makes to housing-related purposes including mortgages, home improvement, and construction, although, some S&Ls have entered into educational loans for their customers. An S&L can be granted its charter by either a state or the federal government; in the case of a federal charter, the organization is known as a federal savings and loan. Federally chartered S&Ls have their own system, which functions in a manner similar to that of the Federal Reserve System, called the Federal Home Loan Banks System. Like the Federal Reserve System, the Federal Home Loan Banks System provides an insurance program of up to $100,000 for each account; this program is called the Federal Savings and Loan Insurance Corporation (FSLIC). The Federal Home Loan Banks System also provides membership options for state-chartered S&Ls and an option for just FSLIC coverage for S&Ls that can satisfy certain requirements.

A building and loan association is a special type of S&L that restricts its lending to home mortgages.

The distinctions between these financial organizations have become narrower as federal legislation has expanded the range of services that can be offered by each type of institution.

Bank Financial Structure

Banks are usually incorporated, and like any corporation must be backed by a certain amount of capital (money or other assets). Banking laws specify that banks must maintain a minimum amount of capital. Banks acquire capital by selling capital stock to shareholders. The money shareholders pay for the capital stock becomes the working capital of the bank. The working capital is put in a trust fund to protect the bank's depositors. In turn, shareholders receive certificates that prove their ownership of stock in the bank. The working capital of a bank cannot be diminished. Dividends to shareholders must be paid only from the profits or surplus of the bank.

Shareholders have their legal relationship with a bank defined by the terms outlined in the contract to purchase capital stock. With the investment in a bank comes certain rights, such as the right to inspect the bank's books and records and the right to vote at shareholders' meetings. Shareholders may not personally sue a bank, but they can, under appropriate circumstances, bring a stockholder's derivative suit on behalf of the bank (sue a third party for injury done to the bank when the bank fails to sue on its own). Shareholders also are not usually personally liable for the debts and acts of a bank, because the corporate form limits their liability. However, if shareholders have consented to or accepted benefits of unauthorized banking practices or illegal acts of the board of directors, they are not immune from liability.

Bank Officials

The election and term of office of a bank's board of directors are governed by statute or by the charter of the bank. The liabilities and duties of bank officials are prescribed by statute, charter, bylaws, customary banking practices, and employment contracts. Directors and bank officers are both responsible for the conduct and honorable management of a bank's affairs, although their duties and liabilities are not the same.

Officers and directors are liable to a bank for losses it incurs as a result of their illegal, fraudulent, or wrongful conduct. Liability is imposed for Embezzlement, illegal use of funds or other assets, false representation about the bank's condition made to deceive others, or fraudulent purchases or loans. The failure to exercise reasonable care in the execution of their duties also renders officials liable if such failure brings about bank losses. If such losses result from an error in judgment, liability will not be imposed so long as the officials acted in Good_Faith with reasonable skill and care. Officers and directors will not be held liable for the acts of their employees if they exercise caution in hiring qualified personnel and supervise them carefully. Civil actions against bank officials are maintained in the form of stockholders' derivative suits.

Criminal statutes determine the liability of officers and directors for illegal acts against their bank.

Bank Duties

The powers and duties of a bank are determined by the terms of its charter and the legislation under which it was created (either federal or state regulations). A bank can, through its governing board, enact reasonable rules and regulations for the efficient operation of its business.

Deposits A deposit is a sum of money placed in an account to be held by a bank for the depositor. A customer can deposit money by cash or by a check or other document that represents cash. Deposits are how banks survive. The deposited money establishes a debtor and creditor relationship between the bank and the depositor. Most often, the bank pays the depositing customer interest for its use of the money until the customer withdraws the funds. The bank has the right to impose rules and regulations managing the deposit, such as restrictions governing the rate of interest the deposited money will earn and guidelines for its withdrawal.

Collections A primary function of a bank is to make collections of items such as checks and drafts deposited by customers. The bank acts as an agent for the customer. Collection occurs when the drawee bank (the bank ordered by the check to make payment) takes funds from the account of the drawer (its customer who has written the check) and presents it to the collecting bank.

Checks A check is a written order made by a drawer to her or his bank to pay a designated person or organization (the payee) the amount specified on the check. Payment pursuant to the check must be made in strict compliance with its terms. The drawer's account must be reduced by the amount specified on the check. A check is a demand instrument, which means it must be paid by the drawee bank on the demand of, or when presented by, the payee or the agent of the payee, the collecting bank.

A payee usually receives payment of a check upon endorsing it and presenting it to a bank in which the payee has an account. The bank can require the payee to present identification to prove a relationship with the bank, before cashing the check. It has no obligation to cash a check for a person who is not a depositor, since it can refuse payment to a stranger. However, it must honor (pay) a check if the payee has sufficient funds on deposit with the bank to cover the amount paid if the drawer of the check does not have adequate funds in his or her account to pay it.

A certified check is guaranteed by a bank, at the request of its drawer or endorser, to be cashable by the payee or succeeding holder. A bank is not obligated to certify a check, but it usually will do so for a customer who has sufficient funds to pay it, in exchange for a nominal fee. A certified check is considered the same as cash because any bank must honor it when the payee presents it for payment.

A drawer can revoke a check unless it has been certified or has been paid to the payee. The notice of revocation is often called a stop payment order. A check is automatically revoked if the drawer dies before it is paid or certified, since the drawer's bank has no authority to complete the transaction under that circumstance. However, if the drawer's bank does not receive notice of the drawer's death, it is not held liable for the payment or certification of that drawer's checks.

Upon request, a bank must return to the drawer all the checks it has paid, so that the drawer can inspect the canceled checks to ensure that no forgeries or errors have occurred, in adjusting the balance of her or his checking account. This review of checks is usually completed through the monthly statement. If the drawer finds an error or forgery, it is her or his obligation to notify the bank promptly or to accept full responsibility for whatever loss has been incurred.

Bank liabilities A bank has a duty to know a customer's signature and therefore is generally liable for charging the customer's account with a forged check. A bank can recover the loss from the forger but not from the person who in good faith and without knowledge of the crime gave something in exchange for the forged check. If the depositor's Negligence was a factor in the forgery, the bank can be excused from the liability.

A bank is also responsible for determining the genuineness of the endorsement when a depositor presents a check for payment. A bank is liable if it pays a check that has been materially altered, unless the alteration was due to the drawer's fault or negligence. If a bank pays a check that has a forged endorsement, it is liable for the loss if it is promptly notified by the customer. In both cases, the bank is entitled to recover the amount of its loss from the thief or forger.

A drawee bank that is ordered to pay a check drawn on it is usually not entitled to recover payment it has made on a forged check. If, however, the drawee bank can demonstrate that the collecting bank was negligent in its collection duties, the drawee bank may be able to establish a right of recovery.

A bank can also be liable for the wrongful dishonor or refusal to pay of a cheque that it has certified, since by definition of certification it has agreed to become absolutely liable to the payee or holder of the check.

If a bank has paid a check that has been properly revoked by its drawer, it must reimburse the drawer for the loss.

Drawer liabilities A drawer who writes a check for an amount greater than the funds on deposit in his or her checking account is liable to the bank. Such a check, called an overdraft, sometimes results in a loan from the bank to the drawer's account for the amount by which the account is deficient, depending on the terms of the account. In this case, the drawer must repay the bank the amount lent plus interest. The bank can also decide not to provide the deficient funds and can refuse to pay the check, in which case the check is considered "bounced." The drawer then becomes liable to the bank for a handling fee for the check, as well as remaining liable to the payee or subsequent holder of the check for the amount due. Many times, the holder of a returned, or bounced, check will impose another fee on the drawer.

Loans and Discounts A major function of a bank is the issuance of loans to applicants who meet certain qualifications. In a loan transaction, the bank and the debtor execute a promissory note and a separate agreement in which the terms and conditions of the loan are detailed. The interest charged on the amount lent can differ based on many variables. One variable is a benchmark interest rate established by the Federal Reserve Bank Board of Governors, also known as the prime rate, at the time the loan is made. Another variable is the length of repayment. The collateral provided to secure the loan, in case the borrower defaults, can also affect the interest rate. In any case, the interest rate must not exceed that permitted by law. The loan must be repaid according to the terms specified in the loan agreement. In case of default, the agreement determines the procedures to be followed.

Banks also purchase commercial papers, which are commercial loans, at a discount from creditors who have entered into long-term contracts with debtors. A creditor sells a commercial paper to a bank for less than its face value because it seeks immediate payment. The bank profits from the difference between the discount price it paid and the face value of the bond, which it will receive when the debtor has finished repaying the loan. Types of commercial paper are educational loans and home mortgages.

Electronic Banking

Many banks are replacing traditional checks and deposit slips with electronic fund transfer (EFT) systems, which utilize sophisticated computer technology to facilitate banking and payment needs. Routine banking by means of EFT is considered safer, easier, and more convenient for customers.

Many types of EFT systems are available, including automated teller machines; pay-by-phone systems; automatic deposits of regularly received checks, such as paychecks; automated payment of recurring bills; point-of-sale transfers or debit cards, where a customer gives a merchant a card and the amount is automatically transferred from the customer's account; and transfer and payment by customers' home computers.

When an EFT service is arranged, the customer receives an EFT card that will activate the system and the bank is legally required to disclose the terms and conditions of the account. These terms and conditions include the customer's liability and the notification process to follow if an EFT card is lost or stolen; the type of transactions in which a customer can take part; the procedure for correction of errors; and the extent of information that can be disclosed to a third party without improper infringement on the customer's privacy. If a bank is planning to change the terms of an account—for example, by imposing a fee for transactions previously conducted free of charge—the customer must receive written notice before the change will be effective.

Banks must send account statements for EFT transactions on a monthly basis. The statements must have the amount, date, and type of transaction; the customer's account number; the account's opening and closing balances; charges for the transfers or for continuation of the service; and an address and telephone number for referral of account questions or mistakes.

EFT transactions have become a highly competitive area of banking, with banks offering various bonuses such as no fee for the use of a card when the account holder meets certain provisions such as maintaining a minimum balance. Also, the rapid growth of personal and home office computing has increased pressure on banks to provide services on-line. Several computer software companies produce technology that can complete many routine banking services, like automatic bill paying, at a customer's home.

Banks have a wide range of options available for notifying a customer that a check has been directly deposited into her or his account.

If a customer has arranged for automatic payment of regularly recurring bills, like mortgage or utility bills, the customer has a limited period of time, usually up to three days before the payment is made, in which to order the bank to stop payment. When the amount of such bills vary, as with utility bills, the bank must notify the customer of the payment date with sufficient time, so that there will be enough funds in the account to cover the debt.

If the customer discovers a mistake in an account, the bank must be notified orally or in writing after the erroneous statement is received. The bank must investigate the claim.

Often, after several days, the customer's account will be temporarily reaccredited with the disputed amount. After the investigation is complete, the bank is required to notify the customer in writing if it concludes that no error occurred. It must provide copies of its decision and explain how it reached its findings. Then the customer must return the amount of the error if it was reaccredited to his or her account.

A customer is liable if an unauthorized transfer is made because an EFT card or other device is stolen, lost, or used without permission. This liability can be limited if the customer notifies the bank within two business days of the discovery of the misdeed; it is extended to $500 if the customer fails to comply with the notice requirement. A customer can assume unlimited liability if she or he fails to report any unauthorized charges to an account within a specified period after receiving the monthly statement.

A customer is entitled to sue a bank for Compensatory Damages caused by the bank's wrongful failure to perform the terms and conditions of an EFT account, such as refusing to pay a charge if the customer's account has more than adequate funds to do so. The customer can also recover a maximum penalty of $1,000, attorneys' fees, and costs in an action based upon violation of this law.

The expansion of the Internet in the mid 1990s allowed banks to offer many more electronic services to their customers. Although this form of business with banks is certainly convenient, it has also caused a considerable amount of concern regarding the security of transactions conducted in this manner. Although laws designed to prevent Fraud in traditional banking also apply to electronic banking, identifying individuals engaged in fraud can be more difficult when electronic transactions are concerned. On the federal level, the Electronic Funds Transfers Act, 15 U.S.C.A. which provides protection to consumers who are the subject of an unauthorized electronic funds transfer.

The Gramm-Leach-Bliley Financial Modernization Act, PL 106-102 (S 900) November 12, 1999. also modified federal statutory provisions related to electronic banking. Under this act, banks must now disclose the fees they charge for use of their automated teller machines. If the consumer is not provided with proper fee disclosure, an ATM operator cannot impose a service fee concerning any electronic fund transfer initiated by the consumer. Furthermore, the act requires that possible fees be disclosed to a consumer when an ATM card is issued.

Interstate Banking and Branching

In late 1994, the 103d Congress authorized significant reforms to interstate banking and branching law. The Interstate Banking Law (Pub. L. No. 103-328), also referred to as the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, provided the banking industry with major legislative changes. The Interstate Banking Act was expected to accelerate the trend of bank mergers. These mergers are a benefit to the nation's largest banks, which will likely see savings of millions of dollars resulting from streamlining.

Reserve Bank of India1930/1934

The central bank of the country is the Reserve Bank of India (RBI). It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Reserve Bank of India was nationalized in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Boards consist of five members each Central Government appointed for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank.

The Bank was constituted for the need of following:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

Functions of Reserve Bank of India

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank the Reserve Bank of India.

Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-was period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilites and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supereme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

(a) It holds the cash reserves of all the scheduled banks.

(b) It controls the credit operations of banks through quantitative and qualitative controls.

(c) It controls the banking system through the system of licensing, inspection and calling for information.

(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. though there were periods of extreme pressure in favour of or against

the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a varietyof developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies.

Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

Classification of RBIs functions

The monetary functions also known as the central banking functions of the RBI are related to control and regulation of money and credit, i.e., issue of currency, control of bank credit, control of foreign exchange operations, banker to the Government and to the money market. Monetary functions of the RBI are significant as they control and regulate the volume of money and credit in the country.

Equally important, however, are the **non-monetary functions** of the RBI in the context of India's economic backwardness. The supervisory function of the RBI may be regarded as a non-monetary function (though many consider this a monetary function). The promotion of sound banking in India is an important goal of the RBI, **the RBI has been given wide and drastic powers, under the Banking Regulation Act of 1949 - these powers relate to licencing of banks, branch expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation.** Under the RBI's supervision and inspection, the working of banks has greatly improved. Commercial banks have developed into financially and operationally sound and viable units. **The RBI's powers of supervision have now been extended to non-banking financial intermediaries. Since independence, particularly after its nationalisation 1949, the RBI has followed the promotional functions vigorously and has been responsible for strong financial support to industrial and agricultural development in the country.**

Unit -II

- **Banking Regulation Act, 1949**
- **Negotiable Instruments Act 1860**

BANKING REGULATIONS ACT 1949 Separate PDF File attached with same name for further reference and reading of bare Act.

The Banking Regulation Act was passed as the Banking Companies Act 1949 and came into force wef 16.3.49. Subsequently it was changed to Banking Regulations Act 1949 wef 01.03.66. Summary of some important sections is provided hereunder. The section no. is given at the end of each item. For details, kindly refer the bare Act.

Banking means accepting for the purpose of lending or investment of deposits of money from public repayable on demand or otherwise and withdrawable by cheque, drafts order or otherwise (5 (i) (b)).

Banking company means any company which transacts the business of banking (5(i)(c)

Transact banking business in India (5 (i) (e).

Demand liabilities are the liabilities which must be met on demand and time liabilities means liabilities which are not demand liabilities (5(i)(f)

Secured loan or advances means a loan or advance made on the security of asset the market value of which is not at any time less than the amount of such loan or advances and unsecured loan or advances means a loan or advance not secured (5(i)(h).

Defines business a banking company may be engaged in like borrowing, lockers, letter of credit, traveller cheques, mortgages etc (6(1).

States that no company shall engage in any form of business other than those referred in Section 6(1) (6(2).

For banking companies carrying on banking business in India to use at least one word bank, banking, banking company in its name (7).

Restrictions on business of certain kinds such as trading of goods etc. (8)

Prohibits banks from holding any immovable property howsoever acquired except as acquired for its own use for a period exceeding 7 years from acquisition of the property. RBI may extend this period by five years (9)

Prohibitions on employments like Chairman, Directors etc (10)

Paid up capital, reserves and rules relating to these (11 & 12)

Banks not to pay any commission, brokerage, discount etc. more than 2.5% of paid up value of one share (13)

Prohibits a banking company from levying any kind of charge upon unpaid capital of a company (section 14) and Section 14(A) prohibits a banking company from creating a floating charge on the undertaking or any property of the company without the RBI permission.

Prohibits payment of dividend by any bank until all of its capitalised expenses have been completely written off (15)

To create reserve fund and 20% of the profits should be transferred to this fund before any dividend is declared (17 (1))

Cash reserve - Non-scheduled banks to maintain 3% of the demand and time liabilities by way of cash reserves with itself or by way of balance in a current account with RBI (18)

Permits banks to form subsidiary company for certain purposes (19)

No banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owners of any amount exceeding 30% of its own paid up share capital + reserves or 30% of the paid up share capital of that company whichever is less. (19(2)).

Restrictions on banks to grant loan to person interested in management of the bank (20)

Power to Reserve Bank to issue directive to banks to determine policy for advances (21)

Every bank to maintain a percentage of its demand and time liabilities by way of cash, gold, unencumbered securities 25%-40% as on last Friday of 2nd preceding fortnight (24).

Return of unclaimed deposits (10 years and above) (26)

Every bank has to publish its balance sheet as on March 31st (29).

Balance sheet is to be got audited from qualified auditors (30 (i))

Publish balance sheet and auditor's report within 3 months from the end of period to which they refer. RBI may extend the period by further three month (31)

Prevent banks from producing any confidential information to any other authority under the Indl Disputes Act. (34A).

RBI authorised to undertake inspection of banks (35).

Amendment carried in the Act during 1983 empowers Central Govt to frame rules specifying the period for which a bank shall preserve its books (45-y), nomination facilities (45ZA to ZF) and return a paid instrument to a customer by keeping a true copy (45Z).

Certain returns are also required to be sent to RBI by banks such as monthly return of liquid assets and liabilities (24-3), quarterly return of assets and liabilities in India (25), return of unclaimed deposits i.e. 10 years and above (26) and monthly return of assets and liabilities under the section (27-1).

<u>Negotiable Instruments Act 1860/ 1881</u>: Separate PDF File attached with same name for reference and detailed study

NEGOTIABLE INSTRUMENTS

The Negotiable Instruments Act 1881 came into force w.e.f. March 01, 1882. It has 147 sections and the Act is applicable to entire India.

DEFINITION OF NEGOTIABLE INSTRUMENTS

Negotiable Instrument (NI) has not been defined directly in the NI Act but as per Section 13, an NI means and include promissory note, bill of exchange and cheque payable to order or bearer.

REQUIREMENTS OF NEGOTIABILITY

All NIs have a special feature called' Negotiability', which means that the NI is:

1. freely transferable by delivery when it is bearer (Section 47) and by delivery and endorsement

when it is an order instrument (Section 48).

2. the transferee taking the instrument for value and in good faith, gets better and absolute title despite any defect in the tide of the transferor (called endorser).

Those instruments which do not fulfil the above two features, cannot be termed negotiable instruments.

INSTRUMENTS MADE PAYABLE TO BEARER

RBI Act 1934 Section 31 states that no person other than RBI or Central Govt. can draw, accept, make or issue any bill of exchange or promissory note payable to bearer on demand. Also Section 31(2) puts a restriction on making a promissory note payable to bearer by a person other than RBI/Central Govt.

PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENTS

Section 118 provides certain presumptions as to NIs, until the contrary is proved:

a: NI was made, drawn, accepted, endorsed and negotiated or transferred for consideration.

b: It bears the date on which it was made or drawn

c: It was accepted within a reasonable time after its date and before maturity.

d: Every transfer of NIs was made before maturity.

e: Endorsements appearing on NI were made in the order in which they appear thereon.

f: It was duly stamped and stamp duly cancelled, when the NI stands lost

g: Holder is holder in due course.

The burden of proof that the instrument is contrary to all/any of the above presumptions is with the person, who challenges such presumption.

PROMISSORY NOTE

(Section 4)

PN is an instrument (a) in writing, (b) containing an unconditional undertaking, (c) signed by the maker, (d) to pay a certain sum of money, (e) to or to the order of a certain person or to the bearer of the instrument. The PNs require to be stamped as per Indian Stamp Act and stamp duty is same for entire India.

Types of Promissory Note

There are two types of PNs, i.e.

Demand Promissory Note (which is payable immediately on demand) and

Usance Promissory Note (payable after a pre-decided definite period).

PNs can be drawn payable in installments also and a provision can be made that on default in payment in one installment, entire amount becomes payable.

Parties to a promissory note:

There are basically two parties i.e. maker (who promises to pay - in case of bank loan, it is borrower) and payee (to whom it is payable - in case of a bank loan, the bank).Currency notes and promissory notes - Currency notes being money, though fulfil a No. of conditions of PNs, are not promissory notes and have been excluded from PN as per Indian Currency Act (Sec 21).

BILL OF EXCHANGE

(Section 5)

A bill of Exchange (BEO) is an instrument (a) in writing, (b) containing an unconditional order, (c) signed by the maker, (d) directing a certain person to pay (e) a certain sum of money only (f) to, or to the order of, a certain person or to the bearer of the instrument.

Parties to a BOE: (u/s 7)

Drawer - The person who orders to pay - may be seller of goods. He is also the creditor.

Drawee - Who is directed to pay - may be a buyer of goods, He is also the debtor. A minor cannot be drawee as he cannot incur liability. .

Payee - Who is authorised to obtain the payment,

Acceptor - The drawee becomes acceptor on acceptance of BOE for payment.

Lost Bill of Exchange - Where a bill is lost, the drawer is under obligation (Sec 45A) to issue a duplicate bill.

CHEQUE

(Section 6)

IS per Section 6, a cheque is (a) a bill of exchange (b) drawn on a specified bank and (c) not expressed to be payable otherwise than on demand.

Parties to a cheque are drawer (the account holder), drawee (the bank with whom the account is maintained), payee (the person named in the cheque). There are other parties also which Come into picture subsequently and include holder, holder in due course, endorser and endorsee.

Electronic Cheques /Truncated Cheques After amendment to Negotiable Instrument Act during December ;2002,. the cheque also means a cheque in Electronic Form containing exact mirror image of a paper cheque with use of digital signatures and asymmetric crypto system. It also include a Truncated Cheque transacted during the clearing process.

Cheque & Bill of Exchange

It is different from a Bill of exchange because

(a) it can be made payable to bearer on demand,

(b) it is drawn on a bank. Drawee can be only a bank and no one else

(c) does not require acceptance

(d) grace period of 3 days for payment is not allowed

(e) notice of dishonour is not necessary

(f) it can be crossed and

(g) cannot be made payable so many days after date.

BANK DRAFT

It is (a) a bill of exchange, (b) drawn by a bank on another or by itself on its other branch. It is very nearly allied to a cheque. However, it can be drawn by a bank only and not by an individual. It cannot be easily countermanded like a cheque and it cannot be made payable to bearer.

HOLDER

(Section 8)

The holder of a BOE, PN or Cheque means any person who is entitled in his own name to the possession thereof and to receive or recover the amount due thereon to the parties thereto.

The definition given in Section 8 implies that:

A: holder must be entitled to the possession of the NI in his own name. Mere legal right to possess is enough and actual possession is not essential. (Say legal heirs of payee of a cheque who are entitled to possess the cheque)

B : holder must be entitled to receive or recover the amount of NI from the parties to the same. Hence he should be a bearer or payee or endorsee. A thief cannot be holder as he is not entitled to receive the amount. A person who was entitled to receive payment of an instrument and the instrument has been lost, he will continue to be treated as holder. Person who finds the instrument lying somewhere will not become its holder by mere possession.

Rights of a holder

a) he can obtain a duplicate of the lost instrument (Section 45-A).

b) he can cross the cheque if not already crossed, convert ~ general crossing to a special crossing and endorse and can negotiate, if the negotiation is not restricted.

c) he can sue in his own name in relation to the instrument.

d) He can complete an inchoate instrument.

e) He can give proper discharge to the person making the payment.

HOLDER IN DUE COURSE

(Section 9)

A holder in due course is any person, who for consideration became the possessor of a promissory note, bill of exchange before the amount mentioned in it becomes payable, or cheque and without having sufficient cause to believe that any defect existed in the title of the person from who he derived his title.

Conditions to become holder in due course

a) Person who claims to be holder in due course must have the negotiable instruments in his possession. He must be payee or endorsee and a bearer.

b) He must obtain possession of it for real, valuable and lawful consideration (and not as a gift) before its maturity (in case of bill), as after maturity of a bill, subsequent holders cannot be the holders in due course, even though they acquire in good faith and for due consideration.

c) He must obtain it in good faith without any sufficient reason to believe that any defect existed in the title of the person from whom he obtained it.

Where holder in due course cannot be there? There cannot be holder in due course in case of not-negotiable crossing and for an instrument the title to which has been obtained through forged endorsement (Forgery does not convey any title as per Section 58).

NEGOTIATION

Negotiation means transferring an instrument from one person to another in such a manner as to convey title and to constitute the transferee the holder thereof.

Bearer instruments - In case of bearer instruments, the negotiation is complete with delivery only.

Order Instruments - The negotiation by endorsement and delivery would be required in case of NIs payable to order.

Importance of Delivery with endorsement

U/s 46 delivery is important to complete negotiation, which may be actual or constructive. Without delivery the property will not be considered to have been transferred. For instance, if a person endorses an instrument and expires without delivery to the endorsee and his legal heirs deliver him, the negotiation has not been completed.

ENDORSEMENTS

As per Section 15, endorsing means signing on the face or backside of an instrument (or even on a piece of paper called Allonge), for the purpose of negotiating a negotiable instrument.

As per Section 50, the endorsement followed by delivery has the effect of transfer of property therein with right of further negotiation. A person who signs and transfers the - property is called endorser and in whose favor it is transferred is called endorsee.

Types of endorsements

The endorsements may be blank or general, special, full, restrictive, partial, conditional or qualified.

Blank endorsements

If the endorser signs his name only, without adding any words or directions, the endorsement is said to be blank or **general endorsement** (Sec 16(1).

An order cheque or bill becomes payable to bearer as per Section 54, if it bears **a blank endorsement.**

Endorsement in full

If an endorser signs his name and adds a direction to pay the amount mentioned in the instrument to, or to order of, a specified person, the endorsement is said to be in full.

Blank endorsements can be converted into full. Endorsement in full followed by endorsement in blank, makes the instrument payable to a bearer.

Restrictive endorsement

Where an endorsement prohibits and restricts the further negotiability of the negotiable instrument, it is called restricted endorsement. The endorser may, by express word, restrict or exclude further right of negotiation or may merely constitute the endorsee as an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person. (Sec50).

Partial endorsement

When an endorser transfers only a part of the amount of the NI to the endorsee, It is called partial endorsement. It is not treated as valid for purpose of negotiation (Sec 56). For instance, where a cheque of Rs.10000 is endorsed as 'Pay Ashok or orders Rs.5000', it will not be a valid endorsement.

Conditional endorsement

An endorsement, which stipulates some conditions, is called conditional endorsement (say Pay to Mr. A when he completes his post-graduation'). The paying bank is not bound to verify fulfilment of such conditions. The conditions are binding between endorser and endorsee only.

Sans Recourse Endorsement

If the holder endorses it in a manner that he does not incur any liability as an endorser (by writing the words like' Pay Sham or, order without recourse to me')

Facultative Endorsement

When endorser reduces rights or increases his liability by express word. Say by writing 'Pay S or order. Notice of dishonour waived', it becomes a facultative endorsement.

Forged endorsement

Where the endorsement is made by a person other than the holder, by signing the name, of holder, it is called forged endorsement. Endorsees (including a Holder in due Course or holder for value) subsequent to the forged endorsement do not derive any title to the instrument.

However, in case of a forged endorsement, the paying bank gets protection u/s 85 (1) provided it is regular.

Endorsement by minor –

A minor can endorse u/s 26, but he will not be liable as an endorser.Liability of endorser

U/s 35, by endorsing an instrument, the endorser impliedly promises that on due presentment, the instrument will be accepted and paid, in case of dishonour of bill, he will compensate the holder, provided the notice of dishonour is given he will not deny to a holder in due course, the genuineness or regularity of a drawer's signature and endorsement and he will not deny the validly of endorsement and his title to the instrument to any subsequent endorsee.

REGULARITY OF ENDORSEMENTS

Section 85 (I) protects a paying banker in case of payment of an order cheque and Section 85-A in case of a bank draft, provided the endorsement is regular (which may be or may not be genuine)

Bankers paying a cheque with irregular endorsement may be held liable for negligence and shall lose the statutory protection.

ENDORSEMENT ON BEARER CHEQUES

A paying bank gets protection u/s 85(2) in respect of a bearer cheque and he need not verify the endorsement, as once a bearer is considered always a bearer. For such endorsements the paying bank is not to take any cognisance.

CROSSING

Crossing of a cheque implies two parallel transverse lines on the face with or without words, such as '& Co', 'not-negotiable', 'payee's account only' etc. These words without lines will not constitute crossing. Such instruments should not be paid as drawer's mandate is not clear (with returning memo as 'crossing incomplete').

Crossing is applicable in case of cheques only and does not cover bill of exchange or promissory note. Important aspect in a crossing is two parallel transverse lines on the face of the cheque. As per NI Act (Section 123 to 131)

The crossing is either general crossing or special crossing.

GENERAL CROSSING

As per Sec 123, general crossing is where a cheque bears across its face two parallel transverse lines (with or without words such as '& co" or any abbreviation. (Words are not important, lines are).

A general crossing, as per Sec 126, is a direction to the paying bank not to pay a cheque across the counter and should be paid to a banker only.

A general crossing can be converted to a special crossing by the drawer or by any holder.

SPECIAL CROSSING

As per Sec 124 where a cheque bears across its face, an addition of the name of the banker, either with or without the words not- negotiable (lines are not important, the writing of name of the bank is important), that addition shall be deemed as special crossing and the cheque shall be considered to be crossed specially to that banker.

As per Sec 126, such cheques shall be paid to that banker to whom it is crossed specially or to his agent for collection. In other words a special crossing is a direction to the paying bank for paying to the bank whose name is there on the face of the cheque.

A cheque crossed to two or more branches of the same bank, is considered to be crossed to one bank only.

NOT NEGOTIABLE CROSSING

As per Section 130, a person taking a cheque crossed generally or specially bearing in either case the words' not negotiable' shall not have and shall not be capable of giving a better title to the cheque than that which the person from whom he took it, had'. If payee of a cheque is
Mr. Ramesh and he obtains the cheque without consideration his title is defective and endorsee for value even, shall also not be able to get a better title. There cannot not be holder in due course for a cheque having 'not-negotiable' crossing.Such crossing does not restrict further transfers but the endorsees do not get a better title than the endorsers.This crossing is also a direction to the collecting banker when its collection is for the account of an endorsee instead of - a payee. Failure to ensure genuineness of the endorsement, may amount to conversion.As regards the paying bank, such crossing does not put additional burden on the paying bank and it has to pay in due, course.

ACCOUNT PAYEE CROSSING

NI Act does not define Account Payee crossing. It is result of custom, use and practice and legal decision, i.e. child of banking practice.

Account Payee crossing is a direction to the collecting bank that the NI should be collected only for the named payee. In case the collecting bank fails to take precaution, it loses the statutory protection.

As regards the paying bank, it has special responsibility even where the collecting bank confirms that the amount is being credited to account of payee only.

PROTECTION TO PAYING BANK FOR CROSSED CHEQUE

Protection is available to a paying bank, u/s 128 of NI Act, according to which a bank is not liable in case of wrong payment when it can prove that the payment has been made in due course, as defined u/s 10.

Section 129 states that the paying banker cannot debit the account of his customer while paying a crossed cheque other than to a bank.

PAYMENT OF CHEQUES

U/s 31 of NI Act, a bank is under statutory obligation to honour the customer's cheque subject to certain conditions. Accordingly the banker must make the payment if these conditions are satisfied (given below), as otherwise the bank has to compensate the drawer for any loss or damage, caused by non-payment:

(a) There are sufficient funds of the drawer available with the bank,

(b) These funds are meant for payment of such cheque,

(c) There is proper demand to make the payment.

PAYMENT IN DUE COURSE

As per Sec 10, a payment would be considered in due course if:

a: Payment is in accordance with the apparent tenor of the instrument.

b: Payment must be made in good faith and without negligence

c: Payment must be made to the person in possession of the instrument

d: Payment must be made under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned therein

e: Payment must be made in money only.

AMOUNT OF A CHEQUE

Where amount of a cheque differs in words and figures, as per Section 18, amount written in words should be paid irrespective of the fact, which amount is less or more.' For instance, if amount in words is Rs. five lac and in figures it is RS.5000/-, the amount written in words only shall be paid.

FORGED CHEQUES OR WHERE DRAWER'S SIGNATURES DIFFER

Where a bank pays a forged cheque, it does not get a discharge, since a forged instrument is not considered a mandate of the customer. Where the bank debits such cheques, it has to restore the credit, even if the forgery is done very cleverly. The burden to prove forgery lies with the drawer.

While the collecting bank gets protection u/s 131 in respect of a forged cheque, if collected for a customer as a crossed cheque, the paying bank does not get any protection except where it is proved that the drawer was a party to the forgery.

In case the drawer's signature do not tally with the ones on bank record, the bank should obtain fresh set of sigm3tures and should not pay the cheques on which the signatures are different, from the ones on the records of the bank.

MATERIAL ALTERATION

Material alteration is an alteration of an NI which brings basic change in the operation/characteristic, of the instrument (i.e. In mandate) and liabilities of the parties thereto, whether the change be beneficial or detrimental.

Material alterations - Alteration would be taken as material when it relates to date, sum payable; time of payment; place of payment; rate of interest; addition of new party; tearing material part of the NI; date of endorsement etc.

Alterations which are not material - Certain alterations are not treated material which Include crossing an uncrossed cheque, filing the date, converting a general crossing to a special crossing etc.

Who can correct? The drawer of a cheque only and no one else can correct material alterations. .

Protection - Payment of a materially altered cheque Is not considered a payment In due course u/s 10 and bank will have to make good the loss if any. Section 89, protects a banker only if the material alteration is not apparent i.e. It is done in such a way that it cannot be detected with reasonable care, prudence and scrutiny.

POST DATED CHEQUES

The cheques which bear a date prior to the date on which it is drawn and the date has not fallen due till presentment, are called post dated cheques. Such cheques become effective on the date mentioned on the body of the cheque and the holder can sue the drawer of such cheque after the mentioned date only. (These cheques are valid cheques and are in the form of usance bill of exchange) The payment of such cheques is not payment in due course and additionally poses following risks to the paying banks:

a) Drawer can stop the payment before the given date,

b) There may be death, insolvency or insanity of the drawer,

c) A garnishee order may be served in respect of the balance in the account .

d) Another cheque of the customer may bounce due to insufficiency of the funds during the period and bank may be held liable for that.

VALIDITY OF CHEQUES AND STALE CHEQUES

As per long established practices and the court decisions, the cheques used to be valid for six months from date of their issue. However u/s 138 of NI Act, it has been provided that to file a complaint in case of dishonoured cheque, for insufficiency of funds, the cheque must be presented within a period, not exceeding 6 month..

A cheque which is not presented for payment for a period of six months from date of its issue is considered to be a stale cheque. Its payment, without revalidation of the drawer, cannot be considered a payment in due course.

The validity of the cheques can be reduced by the drawer by writing on the face of the cheque such words (say, cheque is valid for three months) but it can not be increased beyond 6 months even with express words.

COLLECTION OF CHEQUES

A collecting bank either collects a cheque' as agent (when he collects and credits customer's account) or as a holder for value or holder in due course (when he purchases the cheque from the customer and makes payment before realisation).

Statutory protection

Statutory protection to a collecting banker is available as per Section 131 for cheque and Section 131 (A) for bank drafts. This protection is available when bank acts as agent (and not as a holder for value).

Conditions for protection

Section 131 provides protection only if:

Collection is in good faith and without negligence. Good faith means the bank should have acted bonafide and honestly. Without negligence means with reasonable care, where there was no doubt about the genuineness of the title of the customer to the instrument. In other words, the account should be properly introduced.

Payment is received for a customer. Customer means having an account such as saving bank, current account or term deposit. Protection would not be available if collection is for a noncustomer.

Cheque is generally or specially crossed before coming to the hands of the banker i.e. before these are collected. No protection would be available for an un-crossed cheque.

Duties of collecting bankers

a) To present cheque within a reasonable time (else liable for damages u/s 72 and 84 of NI Act, if customer is put to loss for the delayed presentation)

b) To serve notice of dishonour on the customer, so that the customer can claim the amount from previous parties. If customer incurs loss due to non-receipt of notice from the collecting bank, it may be held liable.

c) To hand over the proceeds after realisation without delay.

Unit III

- **Cyber Laws Relating to Banking,**
- **Banking Companies Act, 1970/ 1980;**
- **Information Technology Act (2000) and its Relevance to Banking**.

CYBER LAWS RELATED TO BANKING SECTOR

And relevance of IT ACT 2000 in Banking sector

Cyber Laws in India

Objectives: This chapter presents the meaning and definition of cyber crime, the legislation in India dealing with offences relating to the use of or concerned with the abuse of computers or other electronic gadgets. The Information Technology Act 2000 and the I.T. Amendment Act 2008 have been dealt with in detail and other legislations dealing with electronic offences have been discussed in brief.

Introduction:

Crime is both a social and economic phenomenon. It is as old as human society. Many ancient books right from pre-historic days, and mythological stories have spoken about crimes committed by individuals be it against another individual like ordinary theft and burglary or against the nation like spying, treason etc. Kautilya's Arthashastra written around 350 BC, considered to be an authentic administrative treatise in India, discusses the various crimes, security initiatives to be taken by the rulers, possible crimes in a state etc. and also advocates punishment for the list of some stipulated offences. Different kinds of punishments have been prescribed for listed offences and the concept of restoration of loss to the victims has also been discussed in it.

Crime in any form adversely affects all the members of the society. In developing economies, cyber crime has increased at rapid strides, due to the rapid diffusion of the Internet and the digitisation of economic activities. Thanks to the huge penetration of technology in almost all walks of society right from corporate governance and state administration, up to the lowest level of petty shop keepers computerizing their billing system, we find computers and other electronic devices pervading the human life. The penetration is so deep that man cannot spend a day without computers or a mobile.

Snatching some one's mobile will tantamount to dumping one in solitary confinement!

Cyber Crime is not defined in Information Technology Act 2000 or in the I.T. Amendment Act 2008 in any other legislation in India. In fact, it cannot be too. Offence or crime has been dealt with elaborately listing various acts and the punishments for each, under the Indian Penal Code, 1860 and quite a few other legislations too. Hence, to define cyber crime, we can say, it is just a combination of crime and computer. To put it in simple terms 'any offence or crime in which a computer is used is a cyber crime'. Interestingly even a petty offence like stealing or pick-pocket can be brought within the broader purview of cyber crime if the basic data or aid to such an offence is a computer or information stored in a computer used (or misused) by the fraudster. The I.T. Act defines a computer, computer network, data, information and all other necessary ingredients that form part of a cyber crime, about which we will now be discussing in detail.

In a cyber crime, computer or the data itself target the object of offence or a tool in committing some other offence, providing the necessary inputs for that offence. All such acts of crime will come under the broader definition of cyber crime.

Let us now discuss in detail, the Information Technology Act -2000 and the I.T. Amendment Act 2008 in general and with particular reference to banking and financial sector related transactions. Before going into the section-wise or chapter-wise description of various provisions of the Act, let us discuss the history behind such a legislation in India, the circumstances under which the Act was passed and the purpose or objectives in passing it.

The Genesis of IT legislation in India: Mid 90's saw an impetus in globalization and computerization, with more and more nations computerizing their governance, and e-commerce seeing an enormous growth. Until then, most of international trade and transactions were done through documents being transmitted through post and by telex only. Evidences and records, until then, were predominantly paper evidences and paper records or other forms of hard-copies only. With much of international trade being done through electronic communication and with email gaining momentum, an urgent and imminent need was felt for recognizing electronic records ie the data what is stored in a computer or an external storage attached thereto.

The United Nations Commission on International Trade Law (UNCITRAL) adopted the Model Law on e-commerce in 1996. The General Assembly of United Nations passed a resolution in January 1997 inter alia, recommending all States in the UN to give favourable considerations to the said Model Law, which provides for recognition to electronic records and according it the same treatment like a paper communication and record.

Objectives of I.T. legislation in India: . It is against this background the Government of India enacted its Information Technology Act 2000 with the objectives as follows, stated in the preface to the Act.

"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."

The Information Technology Act, 2000, was thus passed as the Act No.21 of 2000, got President consent on 9 June and was made effective from 17 October 2000. The Act essentially deals with the following issues:

Legal Recognition of Electronic Documents

Legal Recognition of Digital Signatures

Offenses and Contraventions

Justice Dispensation Systems for cyber crimes.

Amendment Act 2008: Being the first legislation in the nation on technology, computers and ecommerce and e-communication, the Act was the subject of extensive debates, elaborate reviews and detailed criticisms, with one arm of the industry criticizing some sections of the Act to be draconian and other stating it is too diluted and lenient. There were some conspicuous omissions too resulting in the investigators relying more and more on the time-tested (one and half century-old) Indian Penal Code even in technology based cases with the I.T. Act also being referred in the process and the reliance more on IPC rather on the ITA.

RELEVANCE OF IT ACT IN BANKING SECTOR TO PREVANT CYBER CRIMES.

WHY CYBER LAWS ARE FRAMED?

Ref : Article By Prashant Mali

Classification Of Cyber Crimes .It can be classified in to 4 major categories as

(1) Cyber crime against Individual (2) Cyber crime Against Property

(3) Cyber crime Against Organization (4) Cyber crime Against Society

(1) Against Individuals

(i) Email spoofing :
A spoofed email is one in which e-mail header is forged so that mail appears to originate from one source but actually has been sent from another source

(ii) Spamming :
Spamming means sending multiple copies of unsolicited mails or mass e-mails such as chain letters.

(iii) Cyber Defamation :
This occurs when defamation takes place with the help of computers and / or the Internet. E.g. someone publishes defamatory matter about someone on a website or sends e-mails containing defamatory information.

(iv) Harassment & Cyber stalking :
Cyber Stalking Means following the moves of an individual's activity over internet. It can be done with the help of many protocols available such at e- mail, chat rooms, user net groups.

(2) Against Property:

(i) Credit Card Fraud :

(ii) Intellectual Property crimes : These include
Software piracy: illegal copying of programs, distribution of copies of software.
Copyright infringement:
Trademarks violations:
Theft of computer source code:

(iii) Internet time theft :
the usage of the Internet hours by an unauthorized person which is actually paid by another person.

(3) **Against Organisation**

(i) Unauthorized Accessing of Computer:
Accessing the computer/network without permission from the owner.
it can be of 2 forms:

a) Changing/deleting data:
Unauthorized changing of data.

b) Computer voyeur:
The criminal reads or copies confidential or proprietary information, but the data is neither deleted nor changed.

(ii) Denial Of Service :
When Internet server is flooded with continuous bogus requests so as to denying legitimate users to use the server or to crash the server.

(iii) Computer contamination / Virus attack :
A computer virus is a computer program that can infect other computer programs by modifying them in such a way as to include a (possibly evolved) copy of it.
Viruses can be file infecting or affecting boot sector of the computer.
Worms, unlike viruses do not need the host to attach themselves to.

(iv) Email Bombing :

Sending large numbers of mails to the individual or company or mail servers thereby ultimately resulting into crashing.

v) Salami Attack :

When negligible amounts are removed & accumulated in to something larger. These attacks are used for the commission of financial crimes.

(vi) Logic Bomb :

Its an event dependent programme , as soon as the designated event occurs, it crashes the computer, release a virus or any other harmful possibilities.

(vii) Trojan Horse **:**

an unauthorized program which functions from inside what seems to be an authorized program, thereby concealing what it is actually doing.

(viii) Data diddling :

This kind of an attack involves altering raw data just before it is processed by a computer and then changing it back after the processing is completed.

(4) Against Society

(i) Forgery :

currency notes, revenue stamps, mark sheets etc can be forged using computers and high quality scanners and printers.

(ii) Cyber Terrorism :

Use of computer resources to intimidate or coerce others.

(iii) Web Jacking :

Hackers gain access and control over the website of another, even they change the content of website for fulfilling political objective or for money.

BANKING COMPANIES (ACQUISITION AND TRANSFER OF UNDERTAKINGS) ACT,1970

This is an act to provide for the acquisition and transfer of the undertakings of certain banking companies, having regard to their size, resources, coverage and organisation, 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 matter connected therewith or incidental thereto.

Banking Company definition as per act.

Banking company" means any company transacting the business of banking in Reserve , and includes all new banks and special banks;
Explanation.- Any company which is mainly engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.
"**banking**" means the 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, order or otherwise;

"**temporary liability**" means any liability other than demand liability;
"**gold**" means gold in the form of coin, whether legal tender or not, or in the form of bullion or ingot, whether refined or not;
"**register**" shall have the same meaning as in the Companies Act.

Apart from banking , business permitted for a banking company as per the act

In addition to the business of banking, a banking company may engage in all or any of the following forms of business, namely:-

a) the borrowing, raising or taking up of money;
b) the lending or advancing of money either upon or without security;
c) the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hoondees, promissory notes, coupons, drafts,bills of lading, railway receipts, warrants, debentures, certificates, participation term certificates, term finance certificates, musharika certificates, modareka certificates, such other instruments as may be approved by the Reserve Bank, and such other instruments and securities whether transferable or negotiable or not;

d) the granting and issuing of letters of credit, traveller's checks, and circular notes;
e) the buying, selling and dealing in gold and silver coins and coins of other metals;
f) the buying and selling of foreign exchange including foreign bank notes;
g) the acquiring, holding, issuing on commission, underwriting and dealing in stocks, funds, shares, debenture stock, obligations, participation term certificates, term finance certificates, musharika certificates, modareka certificates and such other instruments and investments of any kind as may be approved by the Reserve Bank;
h) the purchasing and selling of bonds, scrips or other forms of securities, participation term certificates, term finance certificates, musharika certificates, modareka certificates and, on behalf of the constituents of the Reserve Bank or others, such other instruments as may be approved by the Reserve Bank;
i) the negotiating of loans and advances;
j) the receiving of all kinds of bonds or other valuables on deposit or for safe custody or otherwise;
k) providing vaults for the safety of the deposits;
l) the collecting and transmitting of money against securities;
m) acting as agents for the Government, local authorities or any other person;
n) the carrying on of agency business of any description including the clearing and forwarding of goods and acting as a law agent on behalf of customers, but excluding the business of a managing agent or treasurer of a company;
o) contracting for public and private loans and negotiating and issuing the same;
p) the effecting, insuring and underwriting of shares, stocks, debentures, debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;
qu) the carrying on and transacting of every kind of guarantee and indemnity business;
r) the buying and acquiring of any kind of property including merchandise, patents, designs, trademarks and copyrights,in addition to, at the normal business period of a bank, such or similar transactions as-

1) repurchase by the seller, or

2) selling in the way called purchase on rent, or

3) repayment of outstanding rates, or

4) leases, or

5) sharing out of revenues, or

6) financing in any other way;

s) bringing into possession any property which may satisfy or partly satisfy any of the claims of the banking company and the managing and borrowing of such property;
t) acquiring, holding and managing of any property or any right,title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

u) undertaking and executing trusts;

v) undertaking the administration of movable and immovable property as executor, trustee or otherwise;
w) for the benefit of employees or ex-employees of the banking company or the dependants and connections of such persons-

1) establishing and supporting, or aiding in the establishment and support of associations, institutions, funds, trusts or any other establishment;
2) granting pensions and allowances;

3) making payments toward insurance;

4) subscribing to any exhibition or any object generally useful;

5) guaranteeing money for all these purposes.

x) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purpose of the banking company;
y) selling, improving, managing, exchanging, leasing, mortgaging or otherwise transferring or turning into acount or otherwise disposing of all or any part of the property or rights of the banking company;
z) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this subsection;
za) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;
zb) any other form of business which the Government may, by notification in the official Gazette, specify as a form of business in which it is lawful for a banking company to engage

As per the act there is Prohibition of certain forms of trading for banking companies.-

No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it, or or engage in any trade or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business as is approved under section 7.

As per the act there is a proper way for Disposal of non-banking assets.-

(1) Notwithstanding anything contained in section 7, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding 7 years from the acquisition thereof or from the commencement of this Act, whichever is later.

(2) Notwithstanding anything contained in subsection (a), the Reserve Bank may extend the period mentioned in subsection (b) by a period not exceeding 5 years where it is satisfied that such extension would be in the interest of the depositors of the banking company.

(3) For the purpose of this section, property a substantial portion of which is used by a banking company for its own genuine requirements shall be deemed to be property for its own use.

As per the act there is a proper way for Restrictions on removal of records and documents.

-No banking company shall remove from its head-office or any of its branches, whether they are at the time being functioning or not, any of its records or documents relating to its business to a place outsideIndia, without the prior permission in writing of the Reserve Bank.

<u>The amendments to the Banking Regulation Act, 1949 ("BR Act"), the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (collectively the "Banking Companies Act")</u> have now been notified. Some of the salient amendments made to the BR Act and Banking Companies Act are discussed below:

<u>Banking Regulation Act:</u>

The ceiling on the voting rights of the shareholders of private sector banks has been enhanced from 10% (Ten Percent) to 26% (Twenty Six Percent).

Banking companies are now allowed to issue 'preference shares' in addition to equity shares. Such issue of such preference shares by banks will however, be subject to regulatory guidelines to be prescribed by the RBI in this regard.

The RBI is now empowered to supersede the entire board of directors ("Board") of any banking company for a period not exceeding 12 (Twelve) months, if it is of the opinion that the functioning of the Board is detrimental to the interest of the depositors and/or the bank.

Prior approval of RBI is now necessary for acquisition by any person of 5% (Five Percent) or more, shares or voting rights of any banking company.

<u>Banking Companies Act :</u>

The ceiling on the voting rights of the shareholders of nationalized banks has now been increased from 1% (One Percent) to 10% (Ten Percent).

Nationalised banks are now permitted to issue two additional instruments namely, 'bonus shares' and 'rights shares' to raise capital for expansion of their banking business.

Nationalised banks are also permitted to increase or decrease their authorized capital with prior approval of Central Government and RBI beyond the ceiling of Rs. 30,00,00,00,000/- (Rupees Three Thousand Crores only) as prescribed under the Banking Companies Act.

The aforesaid amendments in the banking legislations aim at strengthening the regulatory powers of RBI and further developing the banking sector in India which has been struggling to cope with rising defaults in the wake of global slowdown.

IT ACT 2000/2008

The **Information Technology Act 2000** (also known as **ITA-2000**, or the **IT Act**) is an Act of the Indian Parliament (No 21 of 2000) notified on October 17, 2000. This act is being opposed by Save Your Voice campaign and other civil society organizations in India.

History

The United Nations General Assembly by resolution A/RES/51/162, dated the 30 January 1997 has adopted the Model Law on Electronic Commerce adopted by the United Nations Commission on International Trade Law. This is referred to as the UNCITRAL Model Law on E-Commerce. Following the UN Resolution India passed the Information Technology Act 2000 in May 2000, which came into force on October 17, 2000. The Information Technology Act 2000 has been substantially amended through the Information Technology (Amendment) Act 2008 which was passed by the two houses of the Indian Parliament on December 23, and 24, 2008. It got the Presidential assent on February 5, 2009 and came into force on October 27, 2009.

Provisions

Information technology Act 2000 consisted of 94 sections segregated into 13 chapters. Four schedules form part of the Act. In the 2008 version of the Act, there are 124 sections (excluding 5 sections that have been omitted from the earlier version) and 14 chapters. Schedule I and II have been replaced. Schedules III and IV are deleted.

Information Technology Act 2000 addressed the following issues:

1. Legal Recognition of Electronic Documents
2. Legal Recognition of Digital Signatures
3. Offenses and Contraventions
4. Justice Dispensation Systems for Cybercrimes

The Information Technology (Amendment) Act, 2008

The Government of India has brought major amendments to ITA-2000 in form of the Information Technology Amendment Act, 2008. ITAA 2008 (Information Technology Amendment Act 2008) as the new version of Information Technology Act 2000 is often referred has provided additional focus on Information Security. It has added several new sections on offences including Cyber Terrorism and Data Protection. A set of Rules relating to Sensitive Personal Information and Reasonable Security Practices (mentioned in section 43A of the ITAA, 2008) was released in April 2011

Criticism

The amendment was passed in an eventful Parliamentary session on 23rd of December 2008 with no discussion in the House. Some of the cyber law observers have criticized the amendments on the ground of lack of legal and procedural safeguards to prevent violation of civil liberties of Indians. There has also been appreciation about the amendments from many observers because it addresses the issue of Cyber Security.

Section 69 empowers the Central Government/State Government/ its authorized agency to intercept, monitor or decrypt any information generated, transmitted, received or stored in any computer resource if it is necessary or expedient so to do in the interest of the sovereignty or integrity of India, defense of India, security of the State, friendly relations with foreign States or public order or for preventing incitement to the commission of any cognizable offence or for investigation of any offence. They can also secure assistance from computer personnel in decrypting data (see mandatory decryption), under penalty of imprisonment. Section 66A has been criticized and challenged in Lucknow and Madras High Courts for its constitutional validity

Unit IV

- **Securitization Act, (2002).**
- **Recent Trends in Banking Industry (Legal)**

SECURITIZATION ACT 2002

Some Important Definitions as per the Act

Securitization is the financial practice of pooling various types of contractual debt, such as residential mortgages, commercial mortgages, auto loans, or credit card debt obligations, and selling said consolidated debt as bonds, pass-through securities, or collateralized mortgage obligation (CMOs) to various investors. The principal and interest on the debt, underlying the security, is paid back to the various investors regularly. Securities backed by mortgage receivables are called mortgage-backed securities (MBS), while those backed by other types of receivables are asset-backed securities (ABS).

Critics have suggested that the complexity inherent in securitization can limit investors' ability to monitor risk, and that competitive securitization markets with multiple securitize may be particularly prone to sharp declines in underwriting standards. Private, competitive mortgage securitization is believed to have played an important role in the US subprime mortgage crisis.

In addition, off–balance sheet treatment of securitizations along with guarantees from the issuer can hide the extent of leverage of the securitizing firm, thereby facilitating risky capital structures and leading to an under pricing of credit risk. Off–balance sheet securitizations are believed to have played a large role in the high leverage level of US financial institutions before the financial crisis and in the need for bailouts.

The granularity of pools of securitized assets mitigates the credit risk of individual borrowers. Unlike general corporate debt, the credit quality of securitized debt is non-stationary due to changes in volatility that are time and structure-dependent. If the transaction is properly structured and the pool performs as expected, the credit risk of all tranches of structured debt improves; if improperly structured, the affected tranches may experience dramatic credit deterioration and loss.

Securitization has evolved from its tentative beginnings in the late 1970s to an estimated outstanding $10.24 trillion in the United States and $2.25 trillion in Europe as of the 2nd quarter of 2008. In 2007, ABS issuance amounted to $3.455 trillion in the United States and $652 billion in Europe. Whole-business securitization (WBS) arrangements, in which senior creditors of an insolvent business effectively gain the right to control the company, first appeared in the United Kingdom in the 1990s and became common in various Commonwealth legal systems.

The liability book or the funding comes from borrowings. This often comes at a high cost. Securitization allows such banks and finance companies to create a self-funded asset book.

Lower capital requirements: Some firms, due to legal, regulatory, or other reasons, have a limit or range on their permitted leverage. By securitizing some of their assets, which qualifies as a sale for accounting purposes, these firms are able to remove assets from their balance sheets while maintaining the "earning power" of the assets.

Locking in profits: For a given block of business, there is some amount of total profit that have not been emerged in full and thus remains uncertain. Once the block has been securitized, the level of profits has now been locked in for that company. As a result, the risk of profit not emerging, or the benefit of super-profits, has now been passed on.

Transfer risks (credit, liquidity, prepayment, reinvestment, asset concentration): Securitization makes it possible to transfer risks from an entity that does not want to bear them to one that does. Two examples of this are catastrophe bonds and entertainment securitizations. Similarly, by securitizing a block of business, thereby locking in a degree of profits, a company effectively frees up its balance to go out and write more profitable business.

Off balance sheet: Derivatives of many types have in the past been referred to as "off-balance-sheet." This term implies that the use of derivatives has no impact on the balance sheet. While there are differences among the various international accounting standards, there is a general trend towards the requirement to record derivatives at fair value on the balance sheet. It is also a generally accepted principle that, where derivatives are used as a hedge against underlying assets or liabilities, accounting adjustments are required to ensure that the gain or loss on the hedged instrument is recognized in the income statement on a similar basis as the underlying assets and liabilities. Certain credit derivatives products, particularly credit default swaps, now have more or less universally accepted market standard documentation. In the case of credit default swaps, this documentation is formulated by the International Swaps and Derivatives Association, which for a long time provided documentation on how to treat such derivatives on balance sheets.

Earnings: Securitization makes it possible to record an earnings bounce without any real addition to the firm. When a securitization takes place, there often is a "true sale" that takes place between the originator (the parent company) and the SPE. This sale has to be for the market value of the underlying assets in order for the "true sale" to stick, and thus this sale is reflected on the parent company's balance sheet, boosting earnings for that quarter by the amount of the sale. While not illegal, this practice distorts the true earnings of the parent company.

Admissibility: Future cash flows may not receive full credit in a company's accounts (life insurance companies, e.g., may not always receive full credit for future surpluses in their regulatory balance sheet), and a securitization effectively turns an admissible future surplus flow into an admissible immediate cash asset.

Liquidity: Future cash flows may simply be balance sheet items that are not currently available for spending, whereas once the book has been securitized, the cash is available for immediate spending or investment. This also creates a reinvestment book that may be at better rates.

Disadvantages to issuer

May reduce portfolio quality:

If the AAA risks, for example, are securitized out, this leaves a materially worse quality of residual risk.

Costs: Securitizations are expensive due to management and system costs, legal fees, underwriting fees, rating fees, and ongoing administration. An allowance for unforeseen costs is usually essential in a securitization, especially if it is atypical.

Size limitations: Securitizations often require large-scale structuring and thus may not be cost efficient for small- and medium-sized transactions.

Risks: Since securitization is a structured transaction, it may include par structures and credit enhancements that are subject to risks of impairment, such as prepayment, as well as credit loss, especially for structures where there are some retained strips.

Advantages to investors

Opportunity to potentially earn a higher rate of return (on a risk-adjusted basis)

Opportunity to invest in a specific pool of high-quality assets: Due to the stringent requirements for corporations to attain high ratings, there is a dearth of highly rated entities. Securitizations, however, allow for the creation of large quantities of AAA, AA, or A rated bonds, giving risk-averse institutional investors or investors that are required to invest in only highly rated assets access to a larger pool of investment options.

Portfolio diversification: Depending on the securitization, hedge funds and other institutional investors may prefer investing in bonds created through securitizations because they may be uncorrelated to their other bonds and securities.

Isolation of credit risk from the parent entity: Since the assets that are securitized are isolated (at least in theory) from the assets of the originating entity, it may be possible for a securitization to receive a higher credit rating than the "parent" because the underlying risks are different. For example, a small bank may be considered riskier than the mortgage loans it makes to its customers; were the mortgage loans to remain with the bank, the borrowers may effectively be paying higher interest (or, just as likely, the bank would be paying higher interest to its creditors, and hence less profitable).

Risks to investors

Liquidity risk

Credit/default: Default risk is generally accepted as a borrower's inability to meet interest payment obligations on time. For ABS, default may occur when maintenance obligations on the underlying collateral are not sufficiently met as detailed in its prospectus. A key indicator of a particular security's default risk is its credit rating. Different tranches within an ABS are rated differently, with senior classes usually receiving the highest rating and subordinated classes receiving correspondingly lower credit ratings. Almost all mortgages, including reverse mortgages, and student loans are now insured by the government, meaning that taxpayers are on the hook for any of these loans that go bad, even if the asset is massively over-inflated. In other words, there are no limits or curbs on overspending or the liabilities to taxpayers.

However, the credit crisis of 2007–8 exposed a potential flaw in the securitization process: loan originators retain no residual risk for the loans they make but collect substantial fees on loan issuance and securitization, which does not encourage improvement of underwriting standards.

Event risk

Prepayment/reinvestment/early amortization: The majority of revolving ABS are subject to some degree of early amortization risk. The risk stems from specific early amortization events or payout events that cause the security to be paid off prematurely. Typically, payout events include insufficient payments from the underlying borrowers, insufficient excess spread, a rise in the default rate on the underlying loans above a specified level, a decrease in credit enhancements below a specific level, and bankruptcy on the part of the sponsor or servicer.

Currency interest rate fluctuations: Like all fixed-income securities, the prices of fixed-rate ABS move in response to changes in interest rates. Fluctuations in interest rates affect floating-rate ABS prices less than they affect fixed-rate securities, as the index against which the ABS rate adjusts reflects interest rate changes in the economy. Furthermore, interest rate changes may affect the prepayment rates on underlying loans that back some types of ABS, which can affect yields. Home equity loans tend to be the most sensitive to changes in interest rates, while auto loans, student loans, and credit cards are generally less sensitive to interest rates.

Contractual agreements

Moral hazard: Investors usually rely on the deal manager to price the securitizations' underlying assets. If the manager earns fees based on performance, there may be a temptation to mark up the prices of the portfolio assets. Conflicts of interest can also arise with senior note holders when the manager has a claim on the deal's excess spread.

Servicer risk: The transfer or collection of payments may be delayed or reduced if the servicer becomes insolvent. This risk is mitigated by having a backup servicer involved in the transaction.

RECENT TRENDS IN BANKING SECTOR IN INDIA (legal)

1. The banking sector in India emerged largely unscathed from the global financial crisis of 2007-08, but faced a slowdown in the momentum of growth due to the weakening of trade, finance and confidence channels. However, post crisis, the economic growth in most emerging market economies (EMEs) including India recovered, while growth remains anemic in advanced economies. Instability of sovereign debt markets in the Euro zone, political turmoil in the Middle East and North African (MENA) region, calamities in Japan, sovereign debt downgrade of the United States in August this year and the persistently elevated levels of commodity prices have together led to an accentuation of downside risks to global growth. While these risks are expected to recede gradually over time, the long-term sustainability of higher growth in India will depend crucially on the ability of the banking sector to mobilize the savings and meet the credit needs of the growing economy through innovative financial instruments and services that foster financial inclusion and provide efficient and transparent delivery of credit.

2. Despite the challenging headwinds from domestic and international developments, the performance of Indian banks remained robust during 2010-11. The resilience of the banking sector was marked by improvement in the capital base, asset quality and profitability. The profitability of scheduled commercial banks(SCBs) improved both in terms of return on assets (RoA) and return on equity (RoE).Simultaneously, both gross and net NPA ratios declined in comparison with the previous year. Since the Indian financial system is bank dominated, banks' ability to withstand stress is critical to overall financial stability. A series of stress tests conducted by the Reserve Bank in respect of credit, liquidity and interest rate risks showed that banks remained reasonably resilient. However, under extreme shocks, some banks could face moderate liquidity problems and their profitability could be affected.

3. A detailed description of perspectives on global developments is covered in Chapter II on Global Banking Developments. Against this background, some relevant perspectives about the Indian banking sector are outlined.

4. Commercial banks in India have already adopted standardized approaches under Basel

II. It is time for larger banks to seriously consider upgrading their systems and migrating to advanced approaches. Adoption of advanced approaches requires simultaneous use of the underlying processes in the day-to-day risk management of banks. In the background of the recent global regulatory developments, a question often discussed is whether the Indian banks are prepared for Basel III. The building blocks of Basel III are by now quite well known higher and better quality capital; an internationally harmonized leverage ratio to constrain excessive risk taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management. Quick assessments show that at the aggregate level

Indian banks will not have any problem in adjusting to the new capital rules both in terms of quantum and quality. Indian banks are comfortably placed in terms of compliance with the new capital rules.

5. One point to note though is that the comparative position is at the aggregate level; a few individual banks may fall short of the Basel III norms and will have to augment their capital. There will be challenges of upgrading risk management systems and meeting the credit needs of a rapidly growing economy even while adjusting to a more demanding regulatory regime. In addition to countercyclical capital buffers, Basel III also envisages countercyclical provisions.

6. In India, banks have a stock of floating provisions which the Reserve Bank has not permitted to be used, except under a situation of systemic stress. While the floating provisions may serve the purpose of countercyclical provision, a framework is necessary for allowing its use. As an interim measure, the Reserve Bank has been trying to develop a methodology based on the Spanish dynamic provisioning system. This, however, has not been easy given the lack of required data and analytics with the banks. Migration to Basel III requires a high level of liquidity to be maintained through a pool of liquid assets. The definition of liquid assets is very stringent including the requirement that they should be freely available.

7. Converging to global accounting standards, *i.e.,* IFRS facilitates comparability between enterprises operating in different jurisdictions. Convergence would help to reduce both the cost of capital and cost of compliance for industry. Training, education and skill development are cornerstones of a successful IFRS implementation. All the stakeholders including investors, accountants, auditors, customers, software and hardware vendors, rating agencies, analysts, audit committees, actuaries, valuation experts and other specialists will need to develop an understanding of IFRS provisions to varying degrees and what they need to do. It is not only the

accounting issues but how to address the non-accounting issues that will determine how successfully banks make a transition to IFRS. Additionally, banks will need to upgrade their infrastructure, including IT and human resources to face the complexities and challenges of IFRS. Some major technical issues arising for Indian banks during the convergence process are the differences between the IFRS and current regulatory guidelines, in particular, those within the ambit of International Accounting Standard (IAS) 39 replacement project relating to classification and measurement of financial assets and liabilities.

8. Post-crisis, macro-prudential policy has emerged as an important tool for addressing systemic risk, highlighting its time and the cross sectional dimensions. While the time dimension refers to pro-cyclical elements that give rise to the evolution of aggregate risk over time, the cross section dimension is concerned with distribution of risks which can be exacerbated owing to the interconnectedness in the financial system. Financial interconnectedness as a part of macro-financial surveillance is the key issue in discussions on prudential regulation policies as it can magnify idiosyncratic shocks across the financial system. To put in place an effective system of macro-prudential surveillance of the financial system, the Reserve Bank has started using network analysis techniques to model inter-bank exposures. The analysis revealed that the banking sector in India is deeply connected. Further, the contagion analysis made on the basis of network analysis underlined that interconnectedness in the banking sector gives rise to vulnerability of financial system in the event of failure of one or more banks depending on the degree of interaction. The contagion impact is relatively contained due to regulatory limits on interbank exposures. However, the impact may be more significant if other entities like other banks, NBFCs, and mutual funds are included for analysis.

9 The emerging economic environment provides a number of opportunities for the Indian banking sector. Factors like expected positive economic performance, strong savings growth spurred by the favorable demographic dividend, emphasis on expansion of physical infrastructure and the extent of financial exclusion to be bridged will ensure growth of the banking sector in medium term. To exploit emerging opportunities and to benefit from their strengths, Indian banks need to be globally competitive. From a strategic perspective, competitiveness can be achieved by balancing factors such as scale, scope, prudence and knowledge.

10 At present, most of the financial groups in India are led by banks and organized under the Bank Subsidiary model. This model puts the onus on the parent bank for corporate governance, performance and capital requirement of subsidiaries. Besides, the parent carries very substantial reputational risk. The Working Group on 'Introduction of Holding Company structure in India for banks' has recommended migration of major financial conglomerates to the holding company structure to address these limitations to some extent. The main challenges in implementing the recommendations include, formulating a new law governing functioning of financial holding companies, providing right incentives to the existing financial conglomerates

through appropriate tax treatment and resolution of strategic and public policy issues by the Government in the case of public sector banks.

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