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NEGOTIABLE INSTRUMENTS ACT, 1881

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1.0 OBJECTIVES

After reading this lesson, you should be able to-

- Understand meaning, essential characteristics and types of negotiable instruments;
- Describe the meaning and marketing of cheques, crossing of cheques and cancellation of crossing of a cheque;
- Explain capacity and liability parties to a negotiable instruments; and
- Understand various provisions of negotiable instrument Act, 1881 regarding negotiation, assignment, endorsement, acceptance, etc. of negotiable instruments.

1.1 INTRODUCTION

The Negotiable Instruments Act was enacted, in India, in 1881. Prior to its enactment, the provision of the English Negotiable Instrument Act were applicable in India, and the present Act is also based on the English Act with certain modifications. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934. Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorised by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of

money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to be payable on demand or after a certain time. Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are:

1. A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.
2. A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.
3. But a cheque {though a bill of exchange} payable to bearer or demand can be drawn on a person's account with a banker.

1.2 MEANING OF NEGOTIABLE INSTRUMENTS

According to Section 13 (a) of the Act, "Negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or "bearer" appear on the instrument or not."

In the words of Justice, Willis, "A negotiable instrument is one, the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any defects of the title in the person from whom he took it".

Thus, the term, negotiable instrument means a written document which creates a right in favour of some person and which is freely transferable. Although the Act mentions only these three instruments (such as a promissory note, a bill of exchange and cheque), it does not

exclude the possibility of adding any other instrument which satisfies the following two conditions of negotiability:

1. the instrument should be freely transferable (by delivery or by endorsement. and delivery) by the custom of the trade; and
2. the person who obtains it in good faith and for value should get it free from all defects, and be entitled to recover the money of the instrument in his own name.

As such, documents like share warrants payable to bearer, debentures payable to bearer and dividend warrants are negotiable instruments. But the money orders and postal orders, deposit receipts, share certificates, bill of lading, dock warrant, etc. are not negotiable instruments. Although they are transferable by delivery and endorsements, yet they are not able to give better title to the bonafide transferee for value than what the transferor has.

1.3 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT

A negotiable instrument has the following characteristics:

1. Property: The possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument does not merely give possession of the instrument but right to property also. The property in a negotiable instrument can be transferred without any formality. In the case of bearer instrument, the property passes by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transfer of property.

2. Title: The transferee of a negotiable instrument is known as 'holder in due course.' A bona fide transferee for value is not affected by

any defect of title on the part of the transferor or of any of the previous holders of the instrument.

3. Rights: The transferee of the negotiable instrument can sue in his own name, in case of dishonour. A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

4. Presumptions: Certain presumptions apply to all negotiable instruments e.g., a presumption that consideration has been paid under it. It is not necessary to write in a promissory note the words 'for value received' or similar expressions because the payment of consideration is presumed. The words are usually included to create additional evidence of consideration.

5. Prompt payment: A negotiable instrument enables the holder to expect prompt payment because a dishonour means the ruin of the credit of all persons who are parties to the instrument.

1.4 PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENT

Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes in regard to negotiable instruments. In other words these presumptions need not be proved as they are presumed to exist in every negotiable instrument. Until the contrary is proved the following presumptions shall be made in case of all negotiable instruments:

1. Consideration: It shall be presumed that every negotiable instrument was made drawn, accepted or endorsed for consideration. It is presumed that, consideration is present in every negotiable instrument until the contrary is presumed. The presumption of consideration,

however may be rebutted by proof that the instrument had been obtained from, its lawful owner by means of fraud or undue influence.

2. Date: Where a negotiable instrument is dated, the presumption is that it has been made or drawn on such date, unless the contrary is proved.

3. Time of acceptance: Unless the contrary is proved, every accepted bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity. This presumption only applies when the acceptance is not dated; if the acceptance bears a date, it will prima facie be taken as evidence of the date on which it was made.

4. Time of transfer: Unless the contrary is presumed it shall be presumed that every transfer of a negotiable instrument was made before its maturity.

5. Order of endorsement: Until the contrary is proved it shall be presumed that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

6. Stamp: Unless the contrary is proved, it shall be presumed that a lost promissory note, bill of exchange or cheque was duly stamped.

7. Holder in due course: Until the contrary is proved, it shall be presumed that the holder of a negotiable instrument is the holder in due course. Every holder of a negotiable instrument is presumed to have paid consideration for it and to have taken it in good faith. But if the instrument was obtained from its lawful owner by means of an offence or fraud, the holder has to prove that he is a holder in due course.

8. Proof of protest: Section 119 lays down that in a suit upon an instrument which has been dishonoured, the court shall on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

1.5 TYPES OF NEGOTIABLE INSTRUMENT

Section 13 of the Negotiable Instruments Act states that a negotiable instrument is a promissory note, bill of exchange or a cheque payable either to order or to bearer. Negotiable instruments recognised by statute are: (i) Promissory notes (ii) Bills of exchange (iii) Cheques. Negotiable instruments recognised by usage or custom are: (i) Hundis (ii) Share warrants (iii) Dividend warrants (iv) Bankers draft (v) Circular notes (vi) Bearer debentures (vii) Debentures of Bombay Port Trust (viii) Railway receipts (ix) Delivery orders.

This list of negotiable instrument is not a closed chapter. With the growth of commerce, new kinds of securities may claim recognition as negotiable instruments. The courts in India usually follow the practice of English courts in according the character of negotiability to other instruments.

1.5.1 Promissory notes

Section 4 of the Act defines, “A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments.”

Essential elements

An instrument to be a promissory note must possess the following elements:

1. **It must be in writing:** A mere verbal promise to pay is not a promissory note. The method of writing (either in ink or pencil or printing, etc.) is unimportant, but it must be in any form that cannot be altered easily.
2. **It must certainly an express promise or clear understanding to pay:** There must be an express undertaking to pay. A mere acknowledgment is not enough. The following are not promissory notes as there is no promise to pay.

If A writes:

- (a) “Mr. B, I.O.U. (I owe you) Rs. 500”
- (b) “I am liable to pay you Rs. 500”.
- (c) “I have taken from you Rs. 100, whenever you ask for it have to pay” .

The following will be taken as promissory notes because there is an express promise to pay:

If A writes:

- (a) “I promise to pay B or order Rs. 500”
 - (b) “I acknowledge myself to be indebted to B in Rs. 1000 to be paid on demand, for the value received”.
- (3) **Promise to pay must be unconditional:** A conditional undertaking destroys the negotiable character of an otherwise negotiable instrument. Therefore, the promise to pay must not depend upon the happening of some outside contingency or event. It must be payable absolutely.
 - (4) **It should be signed by the maker:** The person who promise to pay must sign the instrument even though it might have

been written by the promisor himself. There are no restrictions regarding the form or place of signatures in the instrument. It may be in any part of the instrument. It may be in pencil or ink, a thumb mark or initials. The promote can be signed by the authorised agent of the maker, but the agent must expressly state as to on whose behalf he is signing, otherwise he himself may be held liable as a maker. The only legal requirement is that it should indicate with certainty the identity of the person and his intention to be bound by the terms of the agreement.

- (5) **The maker must be certain:** The note self must show clearly who is the person agreeing to undertake the liability to pay the amount. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. In case two or more persons promise to pay, they may bind themselves jointly or jointly and severally, but their liability cannot be in the alternative.
- (6) **The payee must be certain:** The instrument must point out with certainty the person to whom the promise has been made. The payee may be ascertained by name or by designation. A note payable to the maker himself is not pronate unless it is indorsed by him. In case, there is a mistake in the name of the payee or his designation; the note is valid, if the payee can be ascertained by evidence. Even where the name of a dead person is entered as payee in ignorance of his death, his legal representative can enforce payment.
- (7) **The promise should be to pay money and money only:** Money means legal tender money and not old and rare coins.

A promise to deliver paddy either in the alternative or in addition to money does not constitute a promissory note.

- (8) The amount should be certain:** One of the important characteristics of a promissory note is certainty—not only regarding the person to whom or by whom payment is to be made but also regarding the amount.

However, paragraph 3 of Section 5 provides that the sum does not become indefinite merely because

- (a) there is a promise to pay amount with interest at a specified rate.
- (b) the amount is to be paid at an indicated rate of exchange.
- (c) the amount is payable by installments with a condition that the whole balance shall fall due for payment on a default being committed in the payment of anyone installment.

- (9) Other formalities:** The other formalities regarding number, place, date, consideration etc. though usually found given in the promissory notes but are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case, omission of date does not invalidate the instrument and the date of execution can be independently ascertained and proved.

On demand (or six month after date) I promise to pay Peter or order the sum of rupees one thousand with interest at 8 per cent per annum until payment.

1.5.2 Bill of exchange

Section 5 of the Act defines, “A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument”.

A bill of exchange, therefore, is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. There are usually three parties to a bill of exchange drawer, acceptor or drawee and payee. Drawer himself may be the payee.

Essential conditions of a bill of exchange

- (1) It must be in writing.
- (2) It must be signed by the drawer.
- (3) The drawer, drawee and payee must be certain.
- (4) The sum payable must also be certain.
- (5) It should be properly stamped.
- (6) It must contain an express order to pay money and money alone.

For example, In the following cases, there is no order to pay, but only a request to pay. Therefore, none can be considered as a bill of exchange:

- (a) “I shall be highly obliged if you make it convenient to pay Rs. 1000 to Suresh”.
- (b) “Mr. Ramesh, please let the bearer have one thousand rupees, and place it to my account and oblige”

However, there is an order to pay, though it is politely made, in the following examples:

- (a) “Please pay Rs. 500 to the order of ‘A’.
 - (b) ‘Mr. A will oblige Mr. C, by paying to the order of P’.
- (7) The order must be unconditional.

Distinction Between Bill of Exchange and Promissory Note

- 1. Number of parties:** In a promissory note there are only two parties – the maker (debtor) and the payee (creditor). In a bill of exchange, there are three parties; drawer, drawee and payee; although any two out of the three may be filled by one and the same person,
- 2. Payment to the maker:** A promissory note cannot be made payable to the maker himself, while in a bill of exchange it can be payable to the drawer and payee or drawee and payee may be the same person.
- 3. Unconditional promise:** A promissory note contains an unconditional promise by the maker to pay to the payee or his order, whereas in a bill of exchange, there is an unconditional order to the drawee to pay according to the direction of the drawer.
- 4. Prior acceptance:** A note is presented for payment without any prior acceptance by the maker. A bill of exchange is payable after sight and must be accepted by the drawee or someone else on his behalf, before it can be presented for payment.
- 5. Primary or absolute liability:** The liability of the maker of a promissory note is primary and absolute, but the liability of the drawer of a bill of exchange is secondary and conditional.
- 6. Relation:** The maker of the promissory note stands in immediate relation with the payee, while the maker or drawer of an accepted bill stands in immediate relation with the acceptor and not the payee.
- 7. Protest for dishonour:** Foreign bill of exchange must be protested for dishonour when such protest is required to be made by the law of the country where they are drawn, but no such protest is needed in the case of a promissory note.

- 8. Notice of dishonour:** When a bill is dishonoured, due notice of dishonour is to be given by the holder to the drawer and the intermediate indorsers, but no such notice need be given in the case of a note.

Classification of Bills

Bills can be classified as:

- (1) Inland and foreign bills.
- (2) Time and demand bills.
- (3) Trade and accommodation bills.

(1) Inland and Foreign Bills

Inland bill: A bill is, named as an inland bill if:

- (a) it is drawn in India on a person residing in India, whether payable in or outside India, or
- (b) it is drawn in India on a person residing outside India but payable in India.

The following are the Inland bills

- (i) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is payable in Bombay. The bill is an inland bill.
- (ii) A bill is drawn by a Delhi merchant on a person in London, but is made payable in India. This is an inland bill.
- (iii) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is accepted for payment in Japan. The bill is an inland bill.

Foreign Bill: A bill which is not an inland bill is a foreign bill. The following are the foreign bills:

1. A bill drawn outside India and made payable in India.

2. A bill drawn outside India on any person residing outside India.
3. A bill drawn in India on a person residing outside India and made payable outside India.
4. A bill drawn outside India on a person residing in India.
5. A bill drawn outside India and made payable outside India.

Bills in sets (Secs. 132 and 133): The foreign bills are generally drawn in sets of three, and each sets is termed as a 'via'.

As soon as anyone of the set is paid, the others becomes inoperative. These bills are drawn in different parts. They are drawn in order to avoid their loss or miscarriage during transit. Each part is despatched separately. To avoid delay, all the parts are sent on the same day; by different mode of conveyance.

Rules: Sections 132 and 133 provide for the following rules:

- (i) A bill of exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue payable only so long as the others remain unpaid. All parts make one bill and the entire bill is extinguished, i.e. when payment is made on one part- the other parts will become inoperative (Section 132).
- (ii) The drawer should sign and deliver all the parts but the acceptance is to be conveyed only on one of the parts. In case a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill (Sec. 132).
- (iii) As between holders in due course of the different parts of the same bill, he who first acquired title to anyone part is

entitled to the other parts and is also entitled to claim the money represented by bill (Sec. 133).

(2) Time and Demand Bill

Time bill: A bill payable after a fixed time is termed as a time bill. In other words, bill payable “after date” is a time bill.

Demand bill: A bill payable at sight or on demand is termed as a demand bill.

(3) Trade and Accommodation Bill

Trade bill: A bill drawn and accepted for a genuine trade transaction is termed as a “trade bill”.

Accommodation bill: A bill drawn and accepted not for a genuine trade transaction but only to provide financial help to some party is termed as an “accommodation bill”.

Example: A, is need of money for three months. He induces his friend B to accept a bill of exchange drawn on him for Rs. 1,000 for three months. The bill is drawn and accepted. The bill is an “accommodation bill”. A may get the bill discounted from his bankers immediately, paying a small sum as discount. Thus, he can use the funds for three months and then just before maturity he may remit the money to B, who will meet the bill on maturity.

In the above example A is the “accommodated party” while B is the “accommodating party”.

It is to be noted that an recommendation bill may be for accommodation of both the drawer arid acceptor. In such a case, they share the proceeds of the discounted bill.

Rules regarding accommodation bills are:

- (i) In case the party accommodated continues to hold the bill till maturity, the accommodating party shall not be liable to him for payment of, the bill since the contract between them is not based on any consideration (Section 43).
- (ii) But the accommodating party shall be liable to any subsequent holder for value who may be knowing the exact position that the bill is an accommodation bill and that the full consideration has not been received by the acceptor. The accommodating party can, in turn, claim compensation from the accommodated party for the amount it has been asked to pay the holder for value.
- (iii) An accommodation bill may be negotiated after maturity. The holder or such a bill after maturity is in the same position as a holder before maturity, provided he takes it in good faith and for value (Sec. 59)

In form and all other respects an accommodation bill is quite similar to an ordinary bill of exchange. There is nothing on the face of the accommodation bill to distinguish it from an ordinary trade bill.

1.5.3 Cheques

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

A cheque is bill of exchange with two more qualifications, namely, (i) it is always drawn on a specified banker, and (ii) it is always payable on demand. Consequently, all cheque are bill of exchange, but all bills are not cheque. A cheque must satisfy all the requirements of a bill of exchange; that is, it must be signed by the drawer, and must contain an

unconditional order on a specified banker to pay a certain sum of money to or to the order of a certain person or to the bearer of the cheque. It does not require acceptance.

Distinction Between Bills of Exchange and Cheque

1. A bill of exchange is usually drawn on some person or firm, while a cheque is always drawn on a bank.
2. It is essential that a bill of exchange must be accepted before its payment can be claimed. A cheque does not require any such acceptance.
3. A cheque can only be drawn payable on demand, a bill may be also drawn payable on demand, or on the expiry of a certain period after date or sight.
4. A grace of three days is allowed in the case of time bills while no grace is given in the case of a cheque.
5. The drawer of the bill is discharged from his liability, if it is not presented for payment, but the drawer of a cheque is discharged only if he suffers any damage by delay in presenting the cheque for payment.
6. Notice of dishonour of a bill is necessary, but no such notice is necessary in the case of cheque.
7. A cheque may be crossed, but not needed in the case of bill.
8. A bill of exchange must be properly stamped, while a cheque does not require any stamp.
9. A cheque drawn to bearer payable on demand shall be valid but a bill payable on demand can never be drawn to bearer.
10. Unlike cheques, the payment of a bill cannot be countermanded by the drawer.

1.5.4 Hundis

A “Hundi” is a negotiable instrument written in an oriental language. The term hundi includes all indigenous negotiable instrument whether they be in the form of notes or bills.

The word ‘hundi’ is said to be derived from the Sanskrit word ‘hundi’, which means “to collect”. They are quite popular among the Indian merchants from very old days. They are used to finance trade and commerce and provide a facile and sound medium of currency and credit.

Hundis are governed by the custom and usage of the locality in which they are intended to be used and not by the provision of the Negotiable Instruments Act. In case there is no customary rule known as to a certain point, the court may apply the provisions of the Negotiable Instruments Act. It is also open to the parties to expressly exclude the applicability of any custom relating to hundis by agreement (Indur Chandra vs. Lachhmi Bibi, 7 B.I.R. 682).

1.6 PARTIES TO NEGOTIABLE INSTRUMENTS

1.6.1 Parties to Bill of Exchange

1. **Drawer:** The maker of a bill of exchange is called the ‘drawer’.
2. **Drawee:** The person directed to pay the money by the drawer is called the ‘drawee’,
3. **Acceptor:** After a drawee of a bill has signed his assent upon the bill, or if there are more parts than one, upon one of such parts and delivered the same, or given notice of such signing to the holder or to some person on his behalf, he is called the ‘acceptor’.

4. **Payee:** The person named in the instrument, to whom or to whose order the money is directed to be paid by the instrument is called the 'payee'. He is the real beneficiary under the instrument. Where he signs his name and makes the instrument payable to some other person, that other person does not become the payee.
5. **Indorser:** When the holder transfers or indorses the instrument to anyone else, the holder becomes the 'indorser'.
6. **Indorsee:** The person to whom the bill is indorsed is called an 'indorsee'.
7. **Holder:** A person who is legally entitled to the possession of the negotiable instrument in his own name and to receive the amount thereof, is called a 'holder'. He is either the original payee, or the indorsee. In case the bill is payable to the bearer, the person in possession of the negotiable instrument is called the 'holder'.
8. **Drawee in case of need:** When in the bill or in any endorsement, the name of any person is given, in addition to the drawee, to be resorted to in case of need, such a person is called 'drawee in case of need'.
In such a case it is obligatory on the part of the holder to present the bill to such a drawee in case the original drawee refuses to accept the bill. The bill is taken to be dishonoured by non-acceptance or for nonpayment, only when such a drawee refuses to accept or pay the bill.
9. **Acceptor for honour:** In case the original drawee refuses to accept the bill or to furnish better security when demanded by the notary, any person who is not liable on the bill, may accept it with the consent of the holder, for the honour of any party liable on the bill. Such an acceptor is called 'acceptor for honour'.

1.6.2 Parties to a Promissory Note

1. **Maker.** He is the person who promises to pay the amount stated in the note. He is the debtor.
2. **Payee.** He is the person to whom the amount is payable i.e. the creditor.
3. **Holder.** He is the payee or the person to whom the note might have been indorsed.
4. The indorser and indorsee (the same as in the case of a bill).

1.6.3 Parties to a Cheque

1. **Drawer.** He is the person who draws the cheque, i.e., the depositor of money in the bank.
2. **Drawee.** It is the drawer's banker on whom the cheque has been drawn.
3. **Payee.** He is the person who is entitled to receive the payment of the cheque.
4. The holder, indorser and indorsee (the same as in the case of a bill or note).

1.7 NEGOTIATION

Negotiation may be defined as the process by which a third party is constituted the holder of the instrument so as to entitle him to the possession of the same and to receive the amount due thereon in his own name. According to section 14 of the Act, 'when a promissory note, bill of exchange or cheque is transferred to any person so as to constitute that person the holder thereof, the instrument is said to be negotiated.' The main purpose and essence of negotiation is to make the transferee of a promissory note, a bill of exchange or a cheque the holder thereof.

Negotiation thus requires two conditions to be fulfilled, namely:

1. There must be a transfer of the instrument to another person; and
2. The transfer must be made in such a manner as to constitute the transferee the holder of the instrument.

Handing over a negotiable instrument to a servant for safe custody is not negotiation; there must be a transfer with an intention to pass title.

1.7.1 Modes of negotiation

Negotiation may be effected in the following two ways:

1. **Negotiation by delivery (Sec. 47):** Where a promissory note or a bill of exchange or a cheque is payable to a bearer, it may be negotiated by delivery thereof.

Example: A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep it for B. The instrument has been negotiated.

2. **Negotiation by endorsement and delivery (Sec. 48):** A promissory note, a cheque or a bill of exchange payable to order can be negotiated only by endorsement and delivery. Unless the holder signs his endorsement on the instrument and delivers it, the transferee does not become a holder. If there are more payees than one, all must endorse it.

1.8 ASSIGNMENT

Bills, notes and cheques represent debts and as such have been held to be assignable without endorsement. Transfer by assignment takes place when the holder of a negotiable instrument sells his right to another person without endorsing it. The assignee is entitled to get

possession and can recover the amount due on the instrument from the parties thereto.

Of the two methods of transfer of negotiable instruments discussed, transfer by negotiation is recognised by the Negotiable Instrument Act.

1.8.1 Negotiation and Assignment Distinguished

The various points of distinction between negotiation and assignment are as below:

1. Negotiation requires delivery only to constitute a transfer, whereas assignment requires a written document signed by the transferor.
2. Consideration is always presumed in the case of transfer by negotiation. In the case of assignment consideration must be proved.
3. In case of negotiation, notice of transfer is not necessary, whereas in the case of assignment notice of the transfer must be given by the assignee to the debtor.
4. The assignee takes the instrument subject to all the defects in the title of the transferor. If the title of the assignor was defective the title of the assignee is also defective. However, in case of negotiation the transferee takes the instrument free from all the defects in the title of the transferor. A holder in due course is not affected by any defect in the title of the transferor. He may therefore have a better title than the transferor.
5. In case of negotiation a transferee can sue the third party in his own name. But an assignee cannot do so.

1.8.2 Importance of delivery in negotiation

Delivery is a voluntary transfer of possession from one person to another. Delivery is essential to complete any contract on a negotiable instrument whether it be contract of making endorsement or acceptance. The property in the instrument does not pass unless the delivery is fully completed. Section 46 of the Act provides that a negotiable instrument is not made or accepted or endorsed unless it is delivered to a proper person. For instance, if a person signs a promissory note and keeps it with himself, he cannot be said to have made a promissory note; only when it is delivered to the payee that the promissory note is made.

Delivery may be actual or constructive. Delivery is actual when it is accompanied by actual change of possession of the instrument. Constructive delivery is effected without any change of actual possession.

1.9 ENDORSEMENT

The word 'endorsement' in its literal sense means, writing on the back of an instrument. But under the Negotiable Instruments Act it means, the writing of one's name on the back of the instrument or any paper attached to it with the intention of transferring the rights therein. Thus, endorsement is signing a negotiable instrument for the purpose of negotiation. The person who effects an endorsement is called an 'endorser', and the person to whom negotiable instrument is transferred by endorsement is called the 'endorsee'.

Essentials of a valid endorsement

The following are the essentials of a valid endorsement:

1. It must be on the instrument. The endorsement may be on the back or face of the instrument and if no space is left on

the instrument, it may be made on a separate paper attached to it called allonage. It should usually be in ink.

2. It must be made by the maker or holder of the instrument. A stranger cannot endorse it.
3. It must be signed by the endorser. Full name is not essential. Initials may suffice. Thumb-impression should be attested. Signature may be made on any part of the instrument. A rubber stamp is not accepted but the designation of the holder can be done by a rubber stamp.
4. It may be made either by the endorser merely signing his name on the instrument (it is a blank endorsement) or by any words showing an intention to endorse or transfer the instrument to a specified person (it is an endorsement in full). No specific form of words is prescribed for an endorsement. But intention to transfer must be present. When in a bill or note payable to order the endorsee's name is wrongly spelt, he should when he endorses it, sign the name as spelt in the instrument and write the correct spelling within brackets after his endorsement.
5. It must be completed by delivery of the instrument. The delivery must be made by the endorser himself or by somebody on his behalf with the intention of passing property therein. Thus, where a person endorses an instrument to another and keeps it in his papers where it is found after his death and then delivered to the endorsee, the latter gets no right on the instrument.
6. It must be an endorsement of the entire bill. A partial endorsement i.e. which purports to transfer to the endorsee a part only of the amount payable does not operate as a valid endorsement.

If delivery is conditional, endorsement is not complete until the condition is fulfilled.

Who may endorse?

The payee of an instrument is the rightful person to make the first endorsement. Thereafter the instrument may be endorsed by any person who has become the holder of the instrument. The maker or the drawer cannot endorse the instrument but if any of them has become the holder thereof he may endorse the instrument. (Sec. 51).

The maker or drawer cannot endorse or negotiate an instrument unless he is in lawful possession of instrument or is the holder there of. A payee or indorsee cannot endorse or negotiate unless he is the holder there of.

Classes of endorsement

An endorsement may be:

- (1) Blank or general.
- (2) Speical or full.
- (3) Partial.
- (4) Restrictive.
- (5) Conditional.

(a) Blank or general endorsement (Sections 16 and 54).

It is an endorsement when the endorser merely signs on the instrument without mentioning the name of the person in whose favour the endorsement is made. Endorsement in blank specifies no endorsee. It simply consists of the signature of the endorser on the endorsement. A negotiable instrument even though payable to order becomes a bearer instrument if endorsed in blank. Then it is transferable by mere delivery. An endorsement in blank may be followed by an endorsement in full.

Example: A bill is payable to X. X endorses the bill by simply affixing his signature. This is an endorsement in blank by X. In this case the bill becomes payable to bearer.

There is no difference between a bill or note indorsed in blank and one payable to bearer. They can both be negotiated by delivery.

(b) Special or full endorsement (Section 16)

When the endorsement contains not only the signature of the endorser but also the name of the person in whose favour the endorsement is made, then it is an endorsement in full. Thus, when endorsement is made by writing the words “Pay to A or A’s order,” followed by the signature of the endorser, it is an endorsement in full. In such an endorsement, it is only the endorsee who can transfer the instrument.

Conversion of endorsement in blank into endorsement in full: When a person receives a negotiable instrument in blank, he may without signing his own name, convert the blank endorsement into an endorsement in full by writing above the endorser’s signature a direction to pay to or to the order of himself or some other person. In such a case the person is not liable as the endorser on the bill. In other words, the person transferring such an instrument does not incur all the liabilities of an endorser. (Section 49).

Example: A is the holder of a bill endorsed by B in blank. A writes over B’s signature the words “Pay to C or order.” A is not liable as endorser but the writing operates as an endorsement in full from B to C.

Where a bill is endorsed in blank, or is payable to bearer and is afterwards endorsed by another in full, the bill remains transferable by delivery with regard to all parties prior to such endorser in full. But such

endorser in full cannot be sued by any one except the person in whose favour the endorsement in full is made. (Section 55).

Example: C the payee of a bill endorses it in blank and delivers it to D, who specially endorses it to E or order. E without endorsement transfers the bill to F. F as the bearer is entitled to receive payment or to sue the drawer, the acceptor, or C who endorsed the bill in blank but he cannot sue D or E.

(c) Partial endorsement (Section 56)

A partial endorsement is one which purports to transfer to the endorsee a part only of the amount payable on the instrument. Such an endorsement does not operate as a negotiation of the instrument.

Example: A is the holder of a bill for Rs.1000. He endorses it “pay to B or order Rs.500.” This is a partial endorsement and invalid for the purpose of negotiation.

(d) Restrictive endorsement (Section 50)

The endorsement of an instrument may contain terms making it restrictive. Restrictive endorsement is one which either by express words restricts or prohibits the further negotiation of a bill or which expresses that it is not a complete and unconditional transfer of the instrument but is a mere authority to the endorsee to deal with bill as directed by such endorsement.

“Pay C,” “Pay C for my use,” “Pay C for the account of B” are instances of restrictive endorsement. The endorsee under a restrictive endorsement acquires all the rights of the endoser except the right of negotiation.

Conditional or qualified endorsement

It is open to the endorser to annex some condition to his own liability on the endorsement. An endorsement where the endorsee limits or negatives his liability by putting some condition in the instrument is called a conditional endorsement. A condition imposed by the endorser may be a condition precedent or a condition subsequent. An endorsement which says that the amount will become payable if the endorsee attains majority embodies a condition precedent. A conditional endorsement unlike the restrictive endorsement does not affect the negotiability of the instrument. It is also some times called qualified endorsement. An endorsement may be made conditional or qualified in any of the following forms:

- (i) **‘Sans recourse’ endorsement:** An endorser may by express word exclude his own liability thereon to the endorser or any subsequent holder in case of dishonour of the instrument. Such an endorsement is called an endorsement sans recourse (without recourse). Thus ‘Pay to A or order sans recourse, ‘pay to A or order without recourse to me,’ are instances of this type of endorsement. Here if the instrument is dishonoured, the subsequent holder or the indorsee cannot look to the indorser for payment of the same.

An agent signing a negotiable instrument may exclude his personal liability by using words to indicate that he is signing as agent only. The same rule applies to directors of a company signing instruments on behalf of a company. The intention to exclude personal liability must be clear.

Where an endorser so excludes his liability and afterwards becomes the holder of the instrument, all intermediate endorsers are liable to him.

Example: A is the holder of a negotiable instrument. Excluding personal liability by an endorsement without recourse, he transfers the instrument to B, and B endorses it

to C, who endorses it to A. A can recover the amount of the bill from B and C.

- (ii) **Facultative endorsement:** An endorsement where the endorser extends his liability or abandons some right under a negotiable instrument, is called a facultative endorsement. “Pay A or order, Notice of dishonour waived” is an example of facultative endorsement.
- (iii) **‘Sans frais’ endorsement:** Where the endorser does not want the endorsee or any subsequent holder, to incur any expense on his account on the instrument, the endorsement is ‘sans frais’.
- (iv) **Liability dependent upon a contingency:** Where an endorser makes his liability depend upon the happening of a contingent event, or makes the rights of the endorsee to receive the amount depend upon any contingent event, in such a case the liability of the endorser will arise only on the happening of that contingent event. Thus, an endorser may write ‘Pay A or order on his marriage with B’. In such a case, the endorser will not be liable until the marriage takes place and if the marriage becomes impossible, the liability of the endorser comes to an end.

Effects of endorsement

The legal effect of negotiation by endorsement and delivery is:

- (i) to transfer property in the instrument from the endorser to the endorsee.
- (ii) to vest in the latter the right of further negotiation, and
- (iii) a right to sue on the instrument in his own name against all the other parties (Section 50).

Cancellation of endorsement

When the holder of a negotiable instrument, without the consent of the endorser destroys or impairs the endorser's remedy against prior party, the endorser is discharged from liability to the holder to the same extent as if the instrument had been paid at maturity (Section 40).

Negotiation back

'Negotiation back' is a process under which an endorsee comes again into possession of the instrument in his own right. Where a bill is re-endorsed to a previous endorser, he has no remedy against the intermediate parties to whom he was previously liable though he may further negotiate the bill.

1.10 INSTRUMENTS WITHOUT CONSIDERATION

A person cannot pass a better title than he himself possesses. A person who is a mere finder of a lost goods or a thief or one who obtains any article by fraud or for an unlawful consideration does not get any title to the thing so acquired. The true owner can recover it not only from him but from any person to whom he may have sold it. But there is a difference between the transfer of ordinary goods and negotiation of negotiable instruments. The Negotiable Instruments Act provides protection to those persons who acquire the instruments in good faith and for valuable consideration. A holder in due course who has no means to discover the defect of title in an instrument of any previous holder when the instrument may have passed through several hands must be protected if he obtains the instrument for value and in good faith.

Section 58 of the Act provides that no person in possession of an instrument with a defect of title can claim the amount of the instrument unless he is a holder in due course. The moment an instrument comes

into the hands of a holder in due course, not only does he get a title which is free from all defects, but having passed through his hands the instrument is cleaned of all defects.

Lost instruments

Where the holder of a bill or note loses it, the finder gets no title to it. The finder cannot lawfully transfer it. The man who lost it can recover it from the finder. But if the instrument is transferable by mere delivery and there is nothing on its face to show that it does not belong to the finder, a holder obtaining it from the finder in good faith and for valuable consideration and before maturity is entitled to the instrument and can recover payment from all the parties thereof. If the instrument is transferable by endorsement, the finder cannot negotiate it except by forging the endorsement.

The holder of the instrument when it is lost must give a notice of loss to all the parties liable on it and also a public notice by advertisement. The holder of a lost bill remains owner in law and as such on maturity can demand payment from the acceptor, and if is dishonoured he must give notice of dishonour to prior parties. The owner of the lost bill has a right to obtain the duplicate from the drawer and on refusal he can sue the drawer for the same.

Stolen instrument

The position of thief of an instrument is exactly the same as that of a finder of lost instruments. A thief acquires no title to an instrument if he receives payment on it the owner can sue him for the recovery of the amount. But if an instrument payable to bearer is stolen and if transferred to a holder in due course, the owner must suffer.

Instruments obtained by fraud

It is of the essence of all contracts including those on negotiable instruments, that they must have been brought about by free consent of the parties competent to contract. Any contract to which consent has been obtained by fraud is voidable at the option of the person whose consent was so obtained. A person who obtains an instrument by fraud gets a defective title. But if such an instrument passes into the hands of a holder in due course, the plea of fraud will not be available against him. If however, it could be shown that a person without negligence on his part was induced to sign an instrument it being represented to him to be a document of a different kind he would not be liable even to a holder in due course.

Instrument obtained for an unlawful consideration

The general rules as to the legality of object or consideration of a contract apply to contracts on negotiable instruments also. An instrument given for an illegal consideration is void and does not convey a valid title to the holder. He cannot enforce payment against any party thereto. Thus, a bill of exchange given in consideration of future illicit cohabitation is void. But if such an instrument passes into the hands of a holder in due course, he obtains a good and complete title to it.

Forged instrument

Forgery confers no title and a holder acquires no title to a forged instrument. A forged instrument is treated as an nullity. Forgery with the intention of obtaining title to an instrument would include:

- (1) fraudulently writing the name of an existing person,
- (2) signing the name of a fictitious person with the intention that it may pass that of a real person, or

- (3) signing one's own name with the intention that the signature may pass as the signature of some other person of the same name.

Example: A bill is payable to Ram Sunder or order. At maturity it wrongfully comes into the possession of another Ram Sunder who knows that he has no claim on the bill. He puts his own signature and the acceptor pays him. The bill is not discharged and the acceptor remains liable to Ram Sunder who is the owner of the bill.

A forged instrument has no existence in the eyes of law. A title which never came into existence cannot be improved even if it passes into the hands of a holder in due course. A forges B's signature on a promissory note and transfers the same to C who takes it in good faith for value. C gets no title of the note even though he is a holder in due course.

Examples: (a) On a note for Rs.1000, A forges B's signature to it as maker. C, a holder who takes it bonafide and for value acquires no title to the note.

- (b) On a bill for Rs.1000 A's acceptance to the bill is forged. The bill comes into hands of B, a bonafide holder for value, B acquires no title to the bill.

Forged endorsement

The case of a forged endorsement is slightly different. If an instrument is endorsed in full, it cannot be negotiated except by an endorsement signed by the person to whom or to whose order the instrument is payable, for the endorsee obtains title only through his endorsement. If an endorsement is forged, the endorsee acquires no title to the instrument even if he is a bonafide purchaser. On the other hand, if the instrument is a bearer instrument or has been endorsed in blank,

and there is a forged endorsement the holder gets a good title because holder in such a case derives title by delivery and not by endorsement. Bankers are specially protected against forged endorsement under section 85 of the Act.

Examples: (a) A bill is endorsed, "Pay X or order." X must endorse the bill and if his signature is forged, the bill is worthless.

(b) A bill is payable to "X or order." It is stolen from X and the thief forges X's endorsement and endorses it to Y who takes it in good faith and for value. Y acquires no title to the bill.

(c) A bill payable to "A or order" is endorsed in blank by A. It comes into the hands of B. B by simple delivery passes it to C. C forges B's endorsement and transfers it to D. As D does not derive his title through the forged endorsement of B, but through the genuine endorsement of A, he obtains a good title to the instrument in spite of the intervening forged endorsement.

Instrument without consideration

Sections 43 to 45 of the Negotiable Instrument Act deal with the consequences of failure or absence of consideration in negotiable instruments. In the case of negotiable instruments consideration is presumed to exist between the parties unless the contrary is proved. As between immediate parties, if an instrument is made, drawn or endorsed without consideration, or for a consideration which subsequently fails, it is void. As between immediate parties, failure of consideration has the same effect as the absence of consideration. For instance if a promissory note is delivered by the maker to the payee as a gift, it cannot be enforced against such maker.

Examples: (a) C the holder of a bill endorses it in blank to D receiving no value. D for value transfers it by delivery to E. E is a holder of value.

(b) A is the holder of a bill for consideration. A endorses it to B, without consideration. The property in the bill passes to B. The bill is dishonoured at maturity. B cannot sue A on the bill.

As between remote parties, the defence of absence or failure of consideration is not available at all. The holder in due course who has paid consideration can recover it from all prior parties immaterial of the fact whether any of them has received consideration or not.

Where there is a partial absence or failure of consideration, as between immediate parties, only that part can be recovered which was actually paid. However, a holder in due course is not affected by this rule. But even between immediate parties, where the part of the consideration which is absent or cannot be ascertained without collateral inquiry, the whole of the amount is recoverable.

Examples: (a) A owes B Rs. 500. B draws a bill on A for Rs. 1000. A to accommodate B and at his request accepts it. If B sues A on the bill he can only recover Rs. 500.

(b) A draws a bill on B for Rs. 500 payable to the order A. B accepts the bill but subsequently dishonours it by non-payment. A sues B on the bill. B proves that it was accepted for value as to Rs. 400 and as an accommodation to A (the plaintiff) for Rs. 100. A can only recover Rs. 400. But if this bill gets into the hands of a holder in due course, he can recover the full amount of Rs. 500.

1.11 HOLDER IN DUE COURSE

Section 9 of the Act defines 'holder in due course' as any person who (i) for valuable consideration, (ii) becomes the possessor of a negotiable instrument payable to bearer or the indorsee or payee thereof, (iii) before the amount mentioned in the document becomes payable, and (iv) without having sufficient cause to believe that any defect existed in the title of the person from whom he derives his title. (English law does not regard payee as a holder in due course).

The essential qualification of a holder in due course may, therefore, be summed up as follows:

1. He must be a holder for valuable consideration. Consideration must not be void or illegal, e.g. a debt due on a wagering agreement. It may, however, be inadequate. A donee, who acquired title to the instrument by way of gift, is not a holder in due course, since there is no consideration to the contract. He cannot maintain any action against the debtor on the instrument. Similarly, money due on a promissory note executed in consideration of the balance of the security deposit for the lease of a house taken for immoral purposes cannot be recovered by a suit.

2. He must have become a holder (passessor) before the date of maturity of the negotiable instrument. Therefore, a person who takes a bill or promissory note on the day on which it becomes payable cannot claim rights of a holder in due course because he takes it after it becomes payable, as the bill or note can be discharged at any time on that day.

3. He must have become holder of the negotiable instrument in good faith. Good faith implies that he should not have accepted the negotiable instrument after knowing about any defect in the title to the instrument. But, notice of defect in the title received subsequent to the acquisition of the title will not affect the rights of a holder in due course. Besides good faith, the Indian Law also requires reasonable care on the

part of the holder before he acquires title of the negotiable instrument. He should take the instrument without any negligence on his part. Reasonable care and due caution will be the proper test of his bona fides. It will not be enough to show that the holder acquired the instrument honestly, if in fact, he was negligent or careless. Under conditions of sufficient indications showing the existence of a defect in the title of the transferor, the holder will not become a holder in due course even though he might have taken the instrument without any suspicion or knowledge.

Example:

- (i) A bill made out by pasting together pieces of a torn bill taken without enquiry will not make the holder, a holder in due course. It was sufficient to show the intention to cancel the bill. A bill should not be taken without enquiry if suspicion has been aroused.
- (ii) A post-dated cheque is not irregular. It will not preclude a bonafide purchase instrument from claiming the rights of a holder in due course.

It is to be noted that it is the notice of the defect in the title of his immediate transferor which deprives a person from claiming the right of a holder in due course. Notice of defect in the title of any prior party does not affect the title of the holder.

4. A holder in due course must take the negotiable instrument complete and regular on the face of it.

Privileges of a holder in due course

1. **Instrument purged of all defects:** A holder in due course who gets the instrument in good faith in the course of its currency is not only himself protected against all defects of title of the person from whom he has received it, but also serves, as a channel to protect all subsequent

holders. A holder in due course can recover the amount of the instrument from all previous parties although, as a matter of fact, no consideration was paid by some of the previous parties to instrument or there was a defect of title in the party from whom he took it. Once an instrument passes through the hands of a holder in due course, it is purged of all defects. It is like a current coin. Who-so-ever takes it can recover the amount from all parties previous to such holder (Sec. 53).

It is to be noted that a holder in due course can purify a defective title but cannot create any title unless the instrument happens to be a bearer one.

Examples:

(i) A obtains Bs acceptance to a bill by fraud. A indorses it to C who takes it as a holder in due course. The instrument is purged of its defects and C gets a good title to it. In case C indorses it to some other person he will also get a good title to it except when he is also a party to the fraud played by A.

(ii) A bill is payable to "A or order". It is stolen from A and the thief forges A's signatures and indorses it to B who takes it as a holder in due course. B cannot recover the money. It is not a case of defective title but a case where title is absolutely absent. The thief does not get any title therefore, cannot transfer any title to it.

(iii) A bill of exchange payable to bearer is stolen. The thief delivers it to B, a holder in due course. B can recover the money of the bill.

2. Rights not affected in case of an inchoate instrument:

Right of a holder in due course to recover money is not at all affected even though the instrument was originally an inchoate stamped instrument and the transferor completed the instrument for a sum greater than what was intended by the maker. (Sec. 20)

3. **All prior parties liable:** All prior parties to the instrument (the maker or drawer, acceptor and intervening indorsers) continue to remain liable to the holder in due course until the instrument is duty satisfied. The holder in due course can file a suit against the parties liable to pay, in his own name (Sec. 36)

4. **Can enforce payment of a fictitious bill:** Where both drawer and payee of a bill are fictitious persons, the acceptor is liable on the bill to a holder in due course. If the latter can show that the signature of the supposed drawer and the first indorser are in the same hand, for the bill being payable to the drawer's order the fictitious drawer must indorse the bill before he can negotiate it. (Sec. 42).

5. **No effect of conditional delivery:** Where negotiable instrument is delivered conditionally or for a special purpose and is negotiated to a holder in due course, a valid delivery of it is conclusively presumed and he acquired good title to it. (Sec. 46).

Example: A, the holder of a bill indorses it "B or order" for the express purpose that B may get it discounted. B does not do so and negotiates it to C, a holder in due course. D acquires a good title to the bill and can sue all the parties on it.

6. **No effect of absence of consideration or presence of an unlawful consideration:** The plea of absence of or unlawful consideration is not available against the holder in due course. The party responsible will have to make payment (Sec. 58).

7. **Estoppel against denying original validity of instrument:** The plea of original invalidity of the instrument cannot be put forth, against the holder in due course by the drawer of a bill of exchange or cheque or by an acceptor for the honour of the drawer. But where the instrument is void on the face of it e.g. promissory note made payable to

“bearer”, even the holder in due course cannot recover the money. Similarly, a minor cannot be prevented from taking the defence of minority. Also, there is no liability if the signatures are forged. (Sec. 120).

8. **Estoppel against denying capacity of the payee to indorsee:** No maker of promissory note and no acceptor of a bill of exchange payable to order shall, in a suit therein by a holder in due course, be permitted to resist the claim of the holder in due course on the plea that the payee had not the capacity to indorse the instrument on the date of the note as he was a minor or insane or that he had no legal existence (Sec 121)

9. **Estoppel against indorser to deny capacity of parties:** An indorser of the bill by his endorsement guarantees that all previous endorsements are genuine and that all prior parties had capacity to enter into valid contracts. Therefore, he on a suit thereon by the subsequent holder, cannot deny the signature or capacity to contract of any prior party to the instrument.

1.12 DISHONOUR OF A NEGOTIABLE INSTRUMENT

When a negotiable instrument is dishonoured, the holder must give a notice of dishonour to all the previous parties in order to make them liable. A negotiable instrument can be dishonoured either by non-acceptance or by non-payment. A cheque and a promissory note can only be dishonoured by non-payment but a bill of exchange can be dishonoured either by non-acceptance or by non-payment.

Dishonour by non-acceptance (Section 91)

A bill of exchange can be dishonoured by non-acceptance in the following ways:

1. If a bill is presented to the drawee for acceptance and he does not accept it within 48 hours from the time of presentment for acceptance. When there are several drawees even if one of them makes a default in acceptance, the bill is deemed to be dishonoured unless these several drawees are partners. Ordinarily when there are a number of drawees all of them must accept the same, but when the drawees are partners acceptance by one of them means acceptance by all.
2. When the drawee is a fictitious person or if he cannot be traced after reasonable search.
3. When the drawee is incompetent to contract, the bill is treated as dishonoured.
4. When a bill is accepted with a qualified acceptance, the holder may treat the bill of exchange having been dishonoured.
5. When the drawee has either become insolvent or is dead.
6. When presentment for acceptance is excused and the bill is not accepted. Where a drawee in case of need is named in a bill or in any indorsement thereon, the bill is not dishonoured until it has been dishonoured by such drawee.

Dishonour by non-payment (Section 92)

A bill after being accepted has got to be presented for payment on the date of its maturity. If the acceptor fails to make payment when it is due, the bill is dishonoured by non-payment. In the case of a promissory note if the maker fails to make payment on the due date the note is dishonoured by non-payment. A cheque is dishonoured by non-payment as soon as a banker refuses to pay.

An instrument is also dishonoured by non-payment when presentment for payment is excused and the instrument when overdue remains unpaid (Sec 76).

Effect of dishonour: When a negotiable instrument is dishonoured either by non acceptance or by non-payment, the other parties thereto can be charged with liability. For example if the acceptor of a bill dishonours the bill, the holder may bring an action against the drawer and the indorsers. There is a duty cast upon the holder towards those whom he wants to make liable to give notice of dishonour to them.

Notice of dishonour: Notice of dishonour means the actual notification of the dishonour of the instrument by non-acceptance or by non-payment. When a negotiable instrument is refused acceptance or payment notice of such refusal must immediately be given to parties to whom the holder wishes to make liable. Failure to give notice of the dishonour by the holder would discharge all parties other than the maker or the acceptor (Sec. 93).

Notice by whom: Where a negotiable instrument is dishonoured either by non- acceptance or by non-payment, the holder of the instrument or some party to it who is liable thereon must give a notice of dishonour to all the prior parties whom he wants to make liable on the instrument (Section 93). The agent of any such party may also be given notice of dishonour. A notice given by a stranger is not valid. Each party receiving notice of dishonour must, in order to render any prior party liable give notice of dishonour to such party within a reasonable time after he has received it. (Sec. 95)

When an instrument is deposited with an agent for presentment and is dishonoured, he may either himself give notice to the parties liable on the instrument or he may give notice to his principal. If he gives

notice to his principal, he must do so within the same time as if he were the holder. The principal, too, in his turn has the same time for giving notice as if the agent is an independent holder. (Sec. 96)

Notice to whom?: Notice of dishonour must be given to all parties to whom the holder seeks to make liable. No notice need be given to a maker, acceptor or drawee, who are the principal debtors (Section 93).

Notice of dishonour may be given to an endorser. Notice of dishonour may be given to a duly authorised agent of the person to whom it is required to be given. In case of the death of such a person, it may be given to his legal representative. Where he has been declared insolvent the notice may be given to him or to his official assignee (Section 94). Where a party entitled to a notice of dishonour is dead, and notice is given to him in ignorance of his death, it is sufficient (Section 97).

Mode of notice: The notice of dishonour may be oral or written or partly oral and partly written. It may be sent by post. It may be in any form but it must inform the party to whom it is given either in express terms or by reasonable intendment that the instrument has been dishonoured and in what way it has been dishonoured and that the person served with the notice will be held liable thereon.

What is reasonable time?: It is not possible to lay down any hard and fast rule for determining what is reasonable time. In determining what is reasonable time, regard shall be had to the nature of the instrument, the usual course the dealings with respect to similar instrument, the distance between the parties and the nature of communication between them. In calculating reasonable time, public holidays shall be excluded (Section 105).

Section 106 lays down two different rules for determining reasonable time in connection with the notice of dishonour (a) when the holder and the party to whom notice is due carry on business or live in different places, (b) when the parties live or carry on business in the same place.

In the first case the notice of dishonour must be dispatched by the next post or on the day next after the day of dishonour. In the second case the notice of dishonour should reach its destination on the day next after dishonour.

Place of notice: The place of business or (in case such party has no place of business) at the residence of the party for whom it is intended, is the place where the notice is to be given. If the person who is to give the notice does not know the address of the person to whom the notice is to be given, he must make reasonable efforts to find the latter's address. But if the party entitled to the notice cannot after due search be found, notice of dishonour is dispensed with.

Duties of the holder upon dishonour

(1) Notice of dishonour. When a promissory note, bill of exchange or cheque is dishonoured by non-acceptance or non-payment the holder must give notice of dishonour to all the parties to the instrument whom he seeks to make liable thereon. (Sec. 93)

(2) Noting and protesting. When a promissory note or bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may cause such dishonour to be noted by a notary public upon the instrument or upon a paper attached thereto or partly upon each (Sec. 99). The holder may also within a reasonable time of the dishonour of the note or bill, get the instrument protested by notary public (Sec. 100).

(3) Suit for money. After the formality of noting and protesting is gone through, the holder may bring a suit against the parties liable for the recovery of the amount due on the instrument.

Instrument acquired after dishonour: The holder for value of a negotiable instrument as a rule, is not affected by the defect of title in his transferor. But this rule is subject to two important exceptions (i) when the holder acquires it after maturity and (ii) when he acquires it with notice of dishonour.

The holder of a negotiable instrument who acquired it after dishonour, whether by non-acceptance or non-payment, with notice thereof, or after maturity, has only, as against the other parties, the rights thereon of his transfer. (Sec. 59).

1.13 NOTING AND PROTESTING

When a negotiable instrument is dishonoured the holder may sue his prior parties i.e the drawer and the indorsers after he has given a notice of dishonour to them. The holder may need an authentic evidence of the fact that a negotiable instrument has been dishonoured. When a cheque is dishonoured generally the bank who refuses payment returns back the cheque giving reasons in writing for the dishonour of the cheque. Sections 99 and 100 provide convenient methods of authenticating the fact of dishonour of a bill of exchange and a promissory note by means of 'noting' and 'protest'.

Noting

As soon as a bill of exchange or a promissory note is dishonoured, the holder can after giving the parties due notice of dishonour, sue the parties liable thereon. Section 99 provides a mode of authenticating the fact of the bill having been dishonoured. Such mode is by noting the

instrument. Noting is a minute recorded by a notary public on the dishonoured instrument or on a paper attached to such instrument. When a bill is to be noted, the bill is taken to a notary public who represents it for acceptance or payment as the case may be and if the drawee or acceptor still refuses to accept or pay the bill, the bill is noted as stated above.

Noting should specify in the instrument, (a) the fact of dishonour, (b) the date of dishonour, (c) the reason for such dishonour, if any (d) the notary's charges, (e) a reference to the notary's register and (f) the notary's initials.

Noting should be made by the notary within a reasonable time after dishonour. Noting and protesting is not compulsory but foreign bills must be protested for dishonour when such protest is required by the law of the place where they are drawn. Cheques do not require noting and protesting. Noting by itself has no legal effect. Still it has some advantages. If noting is done within a reasonable time protest may be drawn later on. Noting without protest is sufficient to allow a bill to be accepted for honour.

Protest

Protest is a formal certificate of the notary public attesting the dishonour of the bill by non-acceptance or by non-payment. After noting, the next step for notary is to draw a certificate of protest, which is a formal declaration on the bill or a copy thereof. The chief advantage of protest is that the court on proof of the protest shall presume the fact of dishonour.

Besides the protest for non-acceptance and for non-payment the holder may protest the bill for better security. When the acceptor of a bill becomes insolvent or suspends payment before the date of maturity, or

when he absconds the holder may protest it in order to obtain better security for the amount due. For this purpose the holder may employ a notary public to make the demand on the acceptor and if refused, protest may be made. Notice of protest may be given to prior parties. When promissory notes and bills of exchange are required to be protested, notice of protest must be given instead of notice of dishonour. (Sec. 102)

Inland bills may or may not be protested. But foreign bills must be protested for dishonour when such protest is required by the law of the place where they are drawn (Sec. 104).

Where a bill is required to be protested under the Act within a specified time, it is sufficient if it is 'noted for protest' within such time. The formal protest may be given at anytime after the noting (Sec. 104A)

Contents of protest

Section 101 of the Act lays down the contents of a regular and perfect protest which are as follows:

1. The instrument itself or a literal transcript of the instrument; and of everything written or printed thereupon.
2. The name of the person for whom and against whom the instrument has been protested.
3. The fact of and reasons for dishonour i.e. a statement that payment or acceptance or better security, as the case may be, has been demanded of such person by the notary public from the person concerned and he refused to give it or did not answer or that he could not be found.
4. The time and place of demand and dishonour.
5. The signature of the notary public.

6. In the case of acceptance for honour or payment for honour the person by whom or for whom such acceptance or payment was offered and effected.

1.14 SUMMARY

A negotiable instrument is a piece of paper which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by endorsement and delivery. The characteristics of a negotiable instrument are easy negotiability, transferee gets good title, transferee gets a right to sue in his own name and certain presumptions which apply to all negotiable instruments. There are two types of negotiable instruments (a) Recognised by statute: Promissory notes, Bill of exchange and cheques and (b) Recognised by usage: Hundis, Bill of lading, Share warrant, Dividend warrant, Railway receipts, Delivery orders etc. The parties to bill of exchange are drawer, drawee, acceptor, payee, indorser, indorsee, holder, drawee in case of need and acceptor for honour. The parties to a promissory note are maker, payee, holder, indorser and indorsee while parties to cheque are drawer, drawee, payee, holder, indorser and indorsee.

Negotiation of an instrument is a process by which the ownership of the instrument is transferred by one person to another. There are two methods of negotiation: by mere delivery and by endorsement. In its literal sense, the term 'indorsement' means writing on an instrument but in its technical sense, under the Negotiable Instrument Act, it means the writing of a person's name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation. A bill may be dishonoured by non-acceptance (since only bills require acceptance) or by non-payment, while a promissory note and cheque may be dishonoured by non-payment only. Noting means recording of the fact of dishonour by a notary public on the bill or paper or both

partly. Protest is a formal notarial certificate attesting the dishonour of the bill. The term 'discharge' in relation to negotiable instrument is used in two senses, viz., (a) discharge of one or more parties from liability thereon, and (b) discharge of the instrument.

1.15 KEYWORDS

Negotiable instrument: A negotiable instrument is one, the property and the title in which is acquired by anyone who takes it as bonafide and for value notwithstanding any defect in the title of the person from whom he/she took it.

Promissory note: A promissory note is an instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to, or to the order of a certain person.

Bills of exchange: A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Accommodation bills: Those bills, which are drawn without any actual consideration, merely, to help out friends and relatives are known as accommodation bills.

Banker's draft: It is a bill of exchange in which a bank orders its branch or another bank, as the case may be, to pay a specified amount to a specified person or to the order of the specified person.

Cheque: Cheque is a kind of bill of exchange, which is always drawn upon a specific bank and is payable on demand.

Crossing of a cheque: When two angular parallel lines are drawn on the face of the cheque, then the cheque said to be crossed.

Usances: The time fixed by the custom of countries for payment of bills drawn in one country but are payable in another country is known as a usance.

Payment in due course: Payment in due course means payment of the instrument after the expiry of the duration of the instrument, in good faith and without any negligence, to the possessor thereof and without the existence of any circumstances that may lead one to believe that the person receiving the payment is not entitled to it.

Assignment: Assignment of any object means the transfer of its title to another person through a written and registered deed under the Transfer of Property Act.

1.16 SELF ASSESSMENT QUESTIONS

1. What is meant by negotiation? How is it effected and how does it differ from an assignment?
2. Define endorsement. What are the various classes of endorsement?
3. Explain the privileges granted to a holder in due course.
4. In what different ways may a negotiable instrument be dishonoured? What are the duties of a holder of a dishonoured bill?
5. How and when should a notice be served on a bill being dishonoured by either non-acceptance or non-payment? Under what circumstances is notice of dishonour unnecessary?

6. What are the various ways in which one or more parties to a negotiable instrument is/are discharged for liability? Discuss.
7. Define the term 'negotiable instrument'. What are its essential characteristics.
8. Discuss the presumptions in respect of a negotiable instrument.
9. What is a bill of exchange? How does it differ from a promissory note.
10. Who are the parties to a negotiable instrument? Discuss.

1.17 REFERENCES/SUGGESTED READINGS

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Subject: **Principles of Insurance and Banking**

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Lesson: **2**

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BANKING LAW AND REGULATION

STRUCTURE

- 2.0 Objectives
- 2.1 Introduction
- 2.2 Title and scope of the act
- 2.3 Definition of banking
- 2.4 Business prohibited for a banking company
- 2.5 Minimum paid-up capital and reserves
- 2.6 Licensing of banking companies
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- 2.8 Restriction on payment of dividend
- 2.9 Cash reserve of non-scheduled banks
- 2.10 Maintenance of liquid assets
- 2.11 Maintenance of assets in India
- 2.12 Annual accounts and balance sheet
- 2.13 Reserve bank's powers of inspection
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- 2.15 Reserve bank's power to control advances
- 2.16 Management of banking companies
- 2.17 Summary
- 2.18 Keywords
- 2.19 Self Assessment questions
- 2.20 References/Suggested readings

2.0 OBJECTIVES

After reading this lesson, you should be able to-

- Discuss purpose and scope of Banking Regulation Act, 1949;
- Understand the various kinds of business that may be undertaken by a banking company;
- Describe the provisions of the Banking Companies Act, 1949 related to adequacy of minimum paid-up capital and reserves, licensing of banks by the Reserve Bank of India, prior permission for opening a new branch, etc.; and
- Understand the provisions such as payment of dividend, maintenance of liquid assets (SLR and CRR), maintenance of annual accounts and balance sheet by a bank, reserve banks powers to safeguard the interests of depositors and shareholders of banks, etc.

2.1 INTRODUCTION

The banking law as we find in India today, is the outcome of the gradual process of evolution. Before 1949, the Indian Companies Act, 1913, contained special provisions relating to banking companies, which were felt inadequate and were subsequently incorporated in the comprehensive legislation passed in 1949 under the name of Banking Companies Act, 1949. Since its enforcement in 1949, this Act was suitably amended a number of times to insert new provisions and to amend the existing ones to suit the needs of changing circumstances and to plug the loopholes in the main legislation. The most significant amendment of the Act was effected by the Banking Laws (Amendment) Act, 1968, which introduced 'Social Control' on banks by inserting regulatory provisions of far-reaching significance. The banking Laws

(Amendment) Act, 1983 inserted a few new sections, besides amending some of the important sections.

Main parts of the Act

The Banking Regulation Act, 1949, as amended upto date, stands divided into the following parts-

- Part I Preliminary (Sections 1 to 5A).
- Part II Business of Banking Companies (Section 6 to 36A).
- Part II A Control over Management (Sections 36AA, and 36A).
- Part II B Prohibition of Certain Activities in relation to Banking Companies (Section 36AD)
- Part II C Acquisition of the undertakings of Banking Companies in Certain Cases (Sections 36AE to 36AJ)
- Part III Suspension of Business and Winding up of Banking Companies (Sections 36B to 45).
- Part III A Special Provisions for Speedy Disposal of Winding Proceedings (Sections 45A to 45X).
- Part III B Provisions Relating to Certain Operations of Banking Companies. (Sections 45Y to 45ZF).
- Part IV Miscellaneous (Sections 46 to 55A)
- Part V Main Provision as applicable to Co-operative Banks (Section 56)

It is to be noted that the main provisions relating to a banking company as a going concern are contained in Parts I, II, IIA, IIB and IIIB. After the nationalisation of major banks the importance of Part IIC is considerably reduced. The following pages deal with the relevant law contained in these parts.

2.2 TITLE AND SCOPE OF THE ACT

Originally enacted as the Banking Companies Act, 1949, the Banking Regulation Act came into force on 16th March, 1949. The word 'Regulation' in the title of the Act was substituted for the word 'Companies' by the amending Act of 1965. With effect from 1st March, 1966 the provisions of the Act, as specified in Part V, have been made applicable to the co-operative banks as well.

Section 2 states that the 'provisions of the Act shall be in addition to and not, save as hereinafter expressly provided, in derogation to the Companies Act, 1956 and any other law for the time being in force'.

After the nationalisation of major banks in india, all the provisions of the Banking Regulation Act, 1949 do not apply to the nationalised banks. However, Sections 5, 6, 10, 13 to 15, 17, 19 to 21, 23 to 28, 29 (exclusive of sub-section 1), 36AD, 46 to 48, 50, 52 and 53 are applicable to the nationalised banks as well (vide banking companies (acquisition and transfer of undertakings) Act, 1970).

2.3 DEFINITION OF BANKING

A banking company is defined as a company which transacts the business of banking by stating the essential functions of bankr. It also states various other businesses a banking company may be engaged in and prohibits certain businesses to be performed by it.

The term 'Banking' is defined as 'accepting, for the purpose of lending or investment, or deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise' [Section 5(b)].

The salient features of this definition are as follows:

(i) A banking company must perform both of the essential functions, viz., (a) accepting deposits, and (b) lending or investing the same. If the purpose of acceptance of deposits is not to lend or invest, the business will not be called banking business. The explanation to Section 5(c) makes it clear that any company which is 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.

(ii) The phrase 'deposit of money from the public' is significant. The banker accepts deposits of money and not of anything else. The word 'public' implies that a banker accepts from any one who offers his/her money for such purpose. The banker, however, can refuse to open an account in the name of a person who is considered as an undesirable person, e.g., a thief, robber, etc. Acceptance of deposits should be the known business of a banker. The money-lenders and indigenous bankers depend on their own resources and do not accept deposits from the public. If they ask for money from their friends or relatives in case of need, such money is not deemed as deposit accepted from the public.

(iii) The definition also specifies the time and mode of withdrawal of the deposits. The deposited money should be repayable to the depositor on demand made by the latter or according to the agreement reached between the two parties. The essential feature of banking business is that the banker does not refund the money on his own accord, even if the period for which it was deposited expires. The depositor must make a demand for the same. The Act also specifies that the withdrawal should be effected through an order, cheque, draft or otherwise. It implies that the demand should be made in a proper manner and through an

instrument in writing and not merely by verbal order or a telephonic message.

It is thus clear that the underlying principle of the business of banking is that the resources mobilised through the acceptance of deposits must constitute main stream of funds which are to be utilised for lending or investment purposes. The banker is, thus, an intermediary and deals with the money belonging to the public. A number of other institutions, which also deal with money, are not designated as banking institutions, because they do not fulfil all the above-mentioned prerequisites. The specialised financial institutions, e.g., Industrial Finance Corporation of India and State Finance Corporations, are not banks because they do not accept the deposits in the prescribed manner. The essence of banking business lies in the two essential functions.

Name must include the word "Bank" or "Banking". Section 7 makes it essential for every company carrying on the business of banking in India to use as part of its name at least one of the words- bank, banker, banking or banking company. Besides, it prohibits any other company or firm, individual or group of individuals, from using any of these words as part of its/his name. After 1983 Amendment, any of these words cannot be used by any such company even 'in connection with its business'.

Other Businesses permitted for a Banking Company- The Banking Regulation Act specifies other forms of businesses a banking company may be engaged in. According to Section 6, the following businesses may be undertaken by a banking company:

- (a) It may undertake the following functions which form the bulk of a bank's activities and are called its main functions:
 - (i) the borrowing, raising or taking of money;
 - (ii) the lending or advancing of money either upon security or without security;

- (iii) the drawing, making, accepting discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not;
 - (iv) the granting and issuing of letters of credit, travellers cheques and circular notes;
 - (v) the buying, selling and dealing in bullion and specie;
 - (vi) the buying and selling of foreign exchange including foreign bank notes;
 - (vii) the acquiring, holding, issuing of commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds;
 - (viii) the purchasing and selling of bonds, scrips and other forms of securities on behalf of constituents or others;
 - (ix) the negotiating of loans and advances;
 - (x) the receiving of all kinds of bonds, scrip or valuables on deposit or for safe custody or otherwise;
 - (xi) the providing of safe deposit vaults; and
 - (xii) the collecting and transmitting of money and securities.
- (b) It may act as an agent of the Government, local authority or person and can carry on agency but it cannot act as secretary and treasurer of a company.
 - (c) It may contract for public and private loans and negotiate and issue the same.
 - (d) It may effect, insure, guarantee, underwrite, participate in managing and carrying out of any issue of State, municipal or other loans or of shares, stock, debentures or debenture

stock of companies and may lend money for the purpose of any such issue.

- (e) It may carry on and transact every kind of guarantee and indemnity business.
- (f) It may manage, sell and realise any property which may come into its possession in satisfaction of its claims.
- (g) It may acquire and hold and deal with any property or any right, title of interest in any such property which may form the security for any loan or advance.
- (h) It may undertake and execute trusts.
- (i) It may undertake the administration of estates as executor, trustee or otherwise.
- (j) It may establish, support and aid associations, institutions funds, trusts, etc., for the benefit of its present or past employees and may grant money for charitable purposes.
- (k) It may acquire, construct and maintain any building for its own purposes.
- (l) It may sell, improve, manage, develop, exchange, lease, mortgage, dispose of or turn into account or otherwise deal with all or any part of the property and rights of the company.
- (m) It may acquire and undertake the whole or any part of the business of any person or company, when such business is of a nature described in Section 6.
- (n) It may do all such things which are incidental or conducive to the promotion or advancement of the business of the company.
- (o) Any other business specified by the Central Government as the lawful business of a banking company.

2.4 BUSINESS PROHIBITED FOR A BANKING COMPANY

Section 8 prohibits a banking company from engaging directly or indirectly in trading activities and undertaking trading risks. No banking company shall directly or indirectly deal in buying or selling or bartering of goods or engage in any trade or buy, sell or barter goods for others. A banking company, however, is permitted to do so for the following purposes:

- (a) to realise the securities given to it or held by it for a loan, if need arises for the realisation of the amount lent.
- (b) to buy or sell or barter for others in connection with (i) bills of exchange received for collection or negotiation, and (ii) undertaking the administration of estates as executor, trustee, etc.

For the purpose of this section, 'goods' means every kind of movable property, other than actionable claims, stocks, shares, money, bullion and specie and all instruments referred to in clause (a) of sub-section (1) of Section 6.

Section 9 prohibits a banking company from holding any immovable property, howsoever acquired, except as is required for its own use for a period exceeding seven years from the acquisition of the property. The Reserve Bank may extend this period by another five years, if it is satisfied that such extension would be in the interest of the depositors of the banking company. The banking company shall be required to dispose of such property within the above-mentioned period.

It may be pointed out that Sections 6(f) and (g) permit a banking company to manage, sell and realise any property which may come into its possession in satisfaction of any of its claims and to acquire, hold and deal with any property which may form part of the security for any loans or advances or which may be connected with any such security.

But according to Section 9 immovable property, howsoever acquired, shall have to be disposed of within a period of 7 years, which may be extended further upto 12 years by the Reserve Bank. Property for its own use can be held by a banking company on a permanent basis.

Restriction on Nature of Subsidiary Companies (Sec. 19)

A banking company is permitted to form a subsidiary company for any or more of the following purposes:

- (a) for undertaking of any business permitted for a banking company under Clauses (a) to (o) of sub-section (1) of Section 6;
- (b) for carrying on the business of banking exclusively outside India (with previous permission of the Reserve Bank); and
- (c) for undertaking of such other business which, in the opinion of Reserve Bank, would be conducive to the spread of banking in India or to be otherwise useful or necessary in the public interest.

The business carried on by such subsidiary company shall not be deemed to be the business of the banking company for the purposes of Section 8.

2.5 MINIMUM PAID-UP CAPITAL AND RESERVES

Adequacy of capital funds- paid-up capital and reserves-is essential for the soundness of a banking concern. Section 11 contains provisions to ensure adequacy of minimum paid-up capital and reserves as follows:

Foreign Banks- In case of a banking company incorporated outside India the aggregate value of its paid-up capital and reserves shall not be less than Rs. 15 lakhs and if it has a place or places of business in the

city of Mumbai or Calcutta or both, Rs. 20 lakhs. The banking company is also required to deposit with the Reserve bank either in cash or in the form of unencumbered approved securities or in both an amount equal to the minimum amount specified above (e.g., Rs. 15 lakhs or Rs. 20 lakhs).

The Act also requires a foreign banking company to deposit with the Reserve Bank at the end of each year an amount equal to 20% of the profit for that year in respect of all business transacted through its branches in India. The Central government may, on the recommendation of the Reserve Bank, exempt any banking company from making deposit of the above-mentioned part of its profits with the Reserve Bank for a period specified in the order. Such exemption will be granted if the amount deposited by the banking company is considered adequate in relation to its deposit liabilities. These amounts shall remain deposited with the Reserve Bank. The banking company is, however, permitted to replace any security so deposited by cash or other security or both and *vice versa*. Sub-section (4) lays down that the afoesadi amounts deposited by foreign banks with the Reserve Bank shall be an asset of the company on which the claims of all the creditors of the company in India shall be a first charge, in case the company ceases to carry on banking business in India.

Indian Banks- For a banking company incorporated in India, the minimum aggregate value of its paid-up capital and reserves is prescribed as follows:

- | | | |
|-----|--|-------------|
| i) | If it has places of business in more than one State | Rs. 5 lakhs |
| ii) | If any such place/places of business is/are situated in Mumbai or Calcutta or both | Rs. 10 lakh |

- iii) If it has all its places of business in one State none of which is situated in the city of Mumbai or Calcutta:
- | | | |
|-----|--|--------------|
| a) | In respect of its principal place of business | Rs. 1 lakh, |
| | | plus |
| b) | In respect of each of its other places of business situated in the district of principal business | Rs. 10,000 |
| | | plus |
| c) | In respect of each place of business situated elsewhere in the State outside the same district subject to a total of Rs. 5 lakhs | Rs. 25,000 |
| iv) | If it has only one place of business | Rs. 50,000 |
| v) | If it has all its places of business in one State, one or more of which is or are situated in the city of Mumbai or Calcutta. | Rs. 5 lakhs, |
| | | plus |
| | In respect of each place of business situated outside the city of Mumbai or Calcutta | Rs. 25,000 |
| | Subject to a total of Rs. 10 lakhs | |

The above requirements apply to those banks which were established before 1962. The Banking Companies (Amendment) Act, 1962, raised the minimum amount of the value of the paid-up capital to Rs. 5 lakhs for any Indian bank commencing business after the commencement of the Act.

The above-mentioned requirement relates to the value of paid-up capital and reserves of a banking company. The term 'Value' has been defined in sub-section (5) so as to mean the 'real' or exchangeable value,

and not the nominal value which may be shown in the books of the banking company. The real or exchangeable value of capital and reserve is computed by estimating the realisable value of all the assets and deducting therefrom the amounts of outside liabilities. The sub-section also lays down that if a dispute arises in computing the aggregate value of the paid-up capital and reserves of any banking company, the determination of the same by Reserve Bank shall be final for the purpose of this Section.

Section 12 provides that the subscribed capital of a banking company should not be less than one-half of its authorised capital and the paid-up capital should not be less than one-half of the subscribed capital. In case the capital is increased, these conditions must be complied with within a maximum period of two years. Banking companies are required to have capital consisting of equity shares only or of equity shares and such preference shares which were issued prior to 1st July, 1944.

Voting Rights- Section 12(2) imposes a limit on the voting rights of a shareholder on poll at 10 per cent of the total voting rights of all the shareholders of the banking company. The limit was raised from 1% to 10% with effect from 31.3.1994.

Section 13 lays down that a banking company shall not pay out directly or indirectly by way of commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, any amount exceeding in the aggregate two and one-half per cent of the paid-up value of shares. This section restricts the amount that may be paid by a banking company as commission, etc., on the issue of shares.

2.6 LICENSING OF BANKING COMPANIES

Section 22 contains a comprehensive system of licensing of banks by the Reserve Bank. This section makes it essential for every banking company to hold a licence issued by the Reserve Bank. The Reserve Bank is required to conduct an inspection of the books of the banking company and issue a licence, if it is satisfied that the following conditions are fulfilled:

- (a) that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
- (b) that the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;
- (c) that the general character of the proposed management of the company will not be prejudicial to the public interest or the interests of its depositors;
- (d) that the company has adequate capital structure and earning prospects;
- (e) that the public interest will be served by the grant of a licence to the company to carry on banking business in India;
- (f) that having regard to the banking facilities available in the proposed principal area of operation of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors, the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;
- (g) any other condition, the fulfilment of which would, in the opinion of the Reserve Bank, be necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.

In case of granting a licence to a banking company incorporated out of India, besides the above-mentioned conditions, the following additional conditions (sub-section 3A) must also be fulfilled, viz.;

- (i) that the carrying on a banking business by such company in India will be in the public interest.
- (ii) that the Government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in India, and
- (iii) that the company complies with all the provisions of the Act applicable to such companies.

It is clear from the above that the grant of a licence depends upon the maintenance of satisfactory financial position. The provision is intended to ensure the continuance and growth only of banks which are established or are operating on sound lines and to discourage indiscriminate floatation of banking companies. To ascertain the position of the company regarding (a) above, the inspecting officer of the Reserve Bank has to make an estimate of the liquid and other readily realisable assets and also to judge whether these assets are enough to meet the claims of the depositors as and when they arise. An assessment about the whole gamut of operations of the banking company and its organisational set-up is necessary to judge the requirement contained in (b) above. The foreign banks have to satisfy the additional conditions (sub-section 3A) before licence can be granted to them.

A banking company, having applied for a licence, may carry on its business until it is served with a notice by the Reserve Bank that a licence cannot be granted to it. The Reserve Bank is also empowered to cancel licence granted to a banking company if at any time any one of the above-mentioned conditions is not continued to be fulfilled: or if the company fails to comply with any of the conditions imposed upon it at

the time of issue of a licence; or it ceases to carry on banking business in India. Before cancelling a licence the Reserve Bank shall grant to the company an opportunity to take necessary steps for complying with or fulfilling such conditions and can specify the terms for doing so. The Reserve Bank can dispense with this rule in case it feels that the delay will be prejudicial to the interests of the company's depositors or the public. An appeal against the decision of the Reserve Bank may be made with the Central Government.

2.7 RESTRICTIONS ON THE OPENING OF BRANCHES

In the matter of branch expansion, Reserve Bank's approval is necessary to avoid unnecessary competition. Section 23 requires every banking company (Indian as well as foreign) to take Reserve Bank's prior permission for opening a new place of business in India or to change the location of an existing place of business in India. Similar permission is also necessary for Indian banks for opening a new place of business outside India or for changing the location of an existing place of business outside India. But for (i) a change of location within the same city, town or village (both in India and abroad), and (ii) opening of a temporary place of business for a maximum period of one month within a city, where the banking company already has a place of business, for the purpose of providing banking facilities to the public on the occasion of an exhibition, a conference or a mela, etc., no permission is required.

The Reserve Bank takes into account the following factors in deciding the application of the bank for opening branches:

- i) the financial condition and history of the company,
 - ii) the general character of its management,
 - iii) the adequacy of its capital structure and earning prospects,
- and

- iv) whether public interest will be served by the opening/change of location of the place of business.

If the Reserve Bank is satisfied by an inspection or otherwise about the above-mentioned factors, permission is granted. The Reserve Bank may also grant permission with certain conditions, compliance of which shall be necessary for the bank concerned. In default of the same, permission given may be revoked.

2.8 RESTRICTION ON PAYMENT OF DIVIDEND

Section 15 prohibits payment of dividend by any banking company until all of its capitalised expenses have been completely written off. These capitalised expenses include preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other expenditure which is not represented by tangible assets. Payment of dividend out of the profits is considered inappropriate when capitalised expenses are outstanding.

A banking company may, however, pay dividends on its shares without writing off the following:

- i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;
- ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for depreciation has been made to the satisfaction of the auditor of the banking company; and

- iii) the bad debts, if any, in case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

2.9 CASH RESERVE OF NON-SCHEDULED BANKS

Section 18 requires a non-scheduled bank to maintain in India, by way of cash reserve, a sum equivalent to at least 3 per cent of the total of its time and demand liabilities in India. This Section does not apply to the scheduled banks as they are required to maintain similar cash reserve with the Reserve Bank of India under Section 42 of the Reserve Bank of India Act, 1934. But the main difference between the provisions of the two sections is that a non-scheduled bank is permitted to maintain cash reserve either (i) with itself, or (ii) in current account opened with the Reserve Bank or the State Bank of India or any other bank notified by the Central Government for this purpose, or (iii) partly in cash with itself and partly in such account or accounts, whereas a scheduled bank is required to maintain such reserve with the Reserve Bank only. The non-scheduled banks may keep the cash reserve as per their convenience.

For the purpose of this Section, the term 'liabilities in India' does not include-

- a) the paid-up capital or the reserves or any credit balance in the profit and loss account of the banking company; and
- b) any advance taken from the Reserve Bank, State Bank of India, Industrial Development Bank of India, or any other bank notified by the Central Government.

Thus the amount of the cash reserves is calculated on the basis of deposit liabilities only.

Non-scheduled banks are required to submit to the Reserve Bank of India a monthly statement showing the amounts of such reserves and the particulars of their time and demand liabilities in India on each Friday. The return is to be submitted by the 15th day of the next month.

2.10 MAINTENANCE OF LIQUID ASSETS

Maintenance of adequate liquid assets is a cardinal principal of sound banking. Section 24 contains statutory requirement in this regard. Every banking company is required to maintain in India in cash, gold or unencumbered approved securities an amount which shall not at the close of business on any day be less than 25 per cent of the total of its net demand and time liabilities in India. This is called the Statutory Liquidity Ratio (SLR). The Reserve Bank is empowered to step up this ratio up to 40% of the net demand and time liabilities so as to compel the banks to keep a large proportion of their liabilities in liquid assets.

It may be mentioned here that despite the absence of the above-mentioned power, the Reserve Bank had raised the statutory liquidity ratio through its power of moral persuasion. The statutory liquidity ratio under Section 24 had been stepped up in successive stages from 25 per cent in January 1970 to 30 per cent in November 1972 and further to 33 per cent subsequently. It was further raised to 34% with effect from Dec. 1, 1978. With every increase in the liquidity ratio, potential for expansion of credit to the commercial sector.

The following points are to be taken into account while complying with the requirements of this Section:

(a) Basis of Maintenance of S.L.R.

S.L.R. is to be maintained as at the close of business on any day. It means that S.L.R. is to be maintained on a daily basis. It should not be

less than 25 per cent of the net demand and time liabilities as obtaining on the last Friday of the second preceding fortnight. For instance, during the period from Saturday, the 28th March, 1998 to Friday the 10th April, 1998, S.L.R. will have to be maintained each day, at the prescribed rate, i.e., 25% of the net Demand and Time Liabilities (D.T.L.) as on Friday, the 13th March, 1998 (i.e., the last Friday of the second preceding fortnight). The Reserve Bank is empowered to raise the percentage of S.L.R. to a higher level but not exceeding 40%.

(b) Valuation of securities

(i) Reserve Bank has the power not only to increase S.L.R., but also the power to decide the mode of valuation of the securities held by the banks. The approved securities are to be valued at a price determined in accordance with such one or more of, or combination of, the following methods of valuation, namely, valuation with reference to cost price, market price, book value or face value as may be specified by the Reserve Bank from time to time. Thus the Reserve Bank possesses the power to specify the mode of valuation of approved securities. As regards the market price, the date of such price is also to be notified by the Reserve Bank in respect of any class or classes of securities. It may be the price as on the date of issue of notification or as on any earlier or later date.

(ii) Approved securities mean the securities in which the trustees may invest trust moneys under clauses (a) to (d) of Section 20 of the Indian Trusts Act, 1882 and such securities which are authorised by the Central Government under Clause (f) of Section 20 of the said Act.

(iii) For the purpose of this Section unencumbered approved securities of a banking company include its approved securities lodged with other institution for securing an advance or any other credit arrangement to the extent to which such securities have not been drawn

against or availed of. For example, if a banking company has taken a loan of Rs. 20,00 only and pledged Government securities of the market value of Rs. 50,00, the balance of the value of the securities (Rs. 50,000 – Rs. 20,000 = Rs. 30,000) would be counted as the value of unencumbered securities for the purpose of Section 24.

(c) Liabilities in India

For the purpose of this Section the term 'liabilities in India' shall not include the following:

- i) the paid-up capital or the reserves or any credit balance in the profit and loss account of the banking company; and
- ii) any advance taken from the Reserve Bank, State Bank of India, Industrial Development Bank of India, NABARD or any other bank notified by the Central Government (Explanation to Section 18).

(d) SLR shall exclude CRR

The banking companies are required to maintain liquid assets including cash, under this Section, in addition to:

- i) the statutory reserves (i.e., the average daily balance) which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act, 1934; and
- ii) the cash reserves which a non-scheduled bank is required to maintain under Section 18 of the Banking Regulation Act, 1949.

(e) Definition of cash maintained in India

The following shall be included in the term cash maintained in India under this section:

- i) Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balances required to be

maintained by it under Section 42. For example, if a banking company maintains an average balance of Rs. 1.5 lakhs with the Reserve Bank under Section 42 while it is required to maintain Rs. 1 lakh only, the average excess amount of Rs. 50,000 shall be deemed as cash for the purpose of Section 24.

- ii) The 'net balance' in current accounts maintained in India by a scheduled bank. The concept of 'net balance' in current accounts was introduced in 1983 so as to reduce the balances of a bank in current accounts with other banks to the extent the bank itself has borrowed from other banks.
- iii) The cash or balances maintained by a non-scheduled bank with itself or with Reserve Bank of India, or by way of net balance in current account in excess of the requirement of Section 18.
- iv) The deposit made by a banking company incorporated outside India with the Reserve Bank under Section 11.
- v) Any balances maintained by a Regional Rural Bank in call or fixed deposit with its sponsor bank.

(f) Submission of monthly return on form VIII

Every banking company shall submit to the Reserve Bank a monthly return showing particulars of its assets maintained in accordance with this Section and its demand and time liabilities in India at the close of business on each alternate Friday during the month. This return shall be submitted within 20 days after the end of the month. Besides, the Reserve Bank may also require a banking company to submit a return showing these figures on each day of the month.

(g) Penalties for default in maintenance of Liquid assets

Then clause relating to imposition of penalties was inserted in 1983. Now, for calculating the amount of liquid assets, the base shall be the figures of demand and time liabilities in India as on the last Friday of the second preceding fortnight. If on any alternate Friday (or preceding working day if Friday is a holiday), the amount maintained by a banking company at the close of business on that day falls below the minimum prescribed under this Section, such banking company shall be liable to pay to the Reserve Bank, in respect of that day's default, penal interest for that day at the rate of 3% per annum above the Bank rate on the amount of shortfall.

If default occurs again on the next succeeding alternate Friday and continues on succeeding alternate Friday, the rate of penal interest shall be increased to 5% per annum above the Bank rate on each such shortfall in respect of that alternate Friday and each succeeding alternate Friday on which default continues.

Even after penal interest at 5% above Bank rate becomes payable. If the default still occurs, every director, manager or secretary of the banking company, who is knowingly and wilfully a party to the default, shall be punishable with fine up to Rs. 500 and with a further fine which may extend to Rs. 500 for each subsequent alternate Friday on which the default continues. Reserve Bank is also empowered not to charge penal interest if it is satisfied with the reason for default.

2.11 MAINTENANCE OF ASSETS IN INDIA

Section 25 requires that the assets in India of every banking company at the close of business on the last Friday of every quarter shall not be less than 75 per cent of its demand and time liabilities in India. In case the said Friday is a public holiday under the Negotiable

Instruments Act, 1881, this should relate to close of the business on the preceding working day.

The primary purpose of this section is to prevent the banking companies, especially the foreign banks, from deploying outside India their deposit resources raised in India and thus to safeguard the interests of depositors in India.

Sub-section 3 of this Section clarifies the following:

- (a) the following bills/securities shall be deemed to be assets held in India, even if all or any of them are held outside India;
 - i) export bills drawn in India and import bills drawn on and payable in India and expressed in such currencies as are approved by the Reserve Bank; and
 - ii) such securities as the Reserve Bank may approve of for this purpose.
- (b) The term 'liabilities in India' shall not include (i) the paid-up capital, or (ii) the reserves, or (iii) any credit balance in the profit and loss account of the banking company.
- (c) The term 'quarter' means the period of 3 months ending on the last day of March, June, September or December.

2.12 ANNUAL ACCOUNTS AND BALANCE SHEET

Every banking company is required to prepare its annual accounts and balance sheet in compliance with the following requirements of Section 29:

(i) The profit and loss account and the balance sheet must be prepared at the expiry of each calendar year or at the expiration of a period of 12 months ending with such date as the Central Government may specify and must relate to the position as on the last working day of the year. The balance sheet must, therefore, be drawn as on such date. However, in case of a foreign company the profit and loss account may be prepared as on a date not earlier than two months before the last working day of the year.

(ii) The profit and loss account and the balance sheet must be in respect of all business transacted by a banking company incorporated in India, i.e., it must include business transacted in India as well as in foreign countries. But in respect of a banking company incorporated outside India, the final accounts must relate to all business transacted through its branches in India.

(iii) The final accounts must be prepared in the forms set out in the Third Schedule to the Act or as near thereto as circumstances admit.

(iv) The final accounts must be signed by the Manager or the principal officer of the company and at least three directors of the company. In case of a foreign banking company, they must be signed by the Manager or agent of the principal office of the company in India.

(v) Banking companies are also required to comply with the requirements of the Companies Act, 1956, relating to preparation of such account so far as the latter are not inconsistent with the provisions of the Banking Regulation Act.

(vi) The accounts and the balance sheet together with the auditor's report should be published in the prescribed manner. Three copies of the same must be furnished as returns to the Reserve Bank of India within three months from the end of the period to which they refer.

The Reserve Bank may extend this period by a further period not exceeding three months (Section 31).

(vii) The banking company shall send to the Registrar of Joint Stock Companies three copies of profit and loss account and the balance sheet and of the auditor's report (Section 32. If the Reserve Bank requires any additional statement or information in connection with the balance sheet and accounts furnished under Section 31, the banking company shall send a copy of such statement or information to the Registrar also [Section 32(2)].

(viii) Every banking company incorporated outside India is required to display in conspicuous place in its principal office and every branch office in India a copy of:

- (a) Its last audited balance sheet and profit and loss account prepared under Section 29, and
- (b) its complete audited balance sheet and profit and loss account relating to its banking business.

The former must be placed for display latest by the first Monday of August every year and the latter as soon as it is made available (Section 33).

2.13 RESERVE BANK'S POWERS OF INSPECTION

The Reserve Bank possesses wide powers to safeguard the interests of the depositors and shareholders of the bank. Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, cause an inspection to be made by one or more of its officers, of any banking company and its books and accounts. Every director, officer or employee of the banking company shall be under an obligation to produce to the Reserve Bank officer all such books,

accounts and other documents in his custody or power and to furnish him with any statements and information relating to the affairs of the banking company as the latter may require within the time specified by him. The Reserve Bank officer is also empowered to examine on oath any director, officer or employee of the banking company in relation to its business.

After the insertion of sub-section (1A) in 1983 it has been clarified that the Reserve Bank has always been empowered to conduct scrutiny of the affairs of then banking companies in addition to conducting regular inspection under Section 35. The officers conducting scrutiny shall have the same powers as that of an inspecting officer.

If on the basis of inspection report submitted by the Reserve Bank, the Central Government is of the opinion that the affairs of the banking company are conducted to the detriment of the interest of its depositors it may be order in writing-

- (a) prohibit the banking company from receiving fresh deposits:
or
- (b) direct the Reserve Bank to apply for the winding up of the banking company. Before passing such an order, the banking company will be given reasonable opportunity to make a representation in connection with the report. The Central Government may defer the passing of such order for some time or cancel or modify any such order upon such terms and conditions as it may think fit to impose. The Central Government may after giving reasonable notice to the banking company publish whole or part of the report submitted by the Reserve Bank.

2.14 RESERVE BANK'S POWER TO ISSUE DIRECTIONS

Section 35A confers powers on the Reserve Bank to issue direction from time to time to banking companies generally or to any banking company in particular if it is satisfied that such directions as it deems fit are necessary-

- (a) in the public interest or in the interest of banking policy, or
- (b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or
- (c) to secure the proper management of any banking company generally.

The banking company/companies shall be bound to comply with such directions which can be modified or cancelled by the Reserve Bank with or without any conditions imposed by it.

Section 36 confers powers on the Reserve Bank to caution or prohibit banking companies either generally or in particular against entering into any particular transaction or class of transactions and generally give advice to any banking company. In the interest of banking policy or public interest or for preventing the affairs of the banking company being conducted in a manner detrimental to the interests of the banking company or its depositors, the Reserve Bank may pass orders-

- i) to require the banking company to call a meeting of the Board of Directors to consider any matter;
- ii) to require an officer of the banking company to discuss any matter with Reserve Bank officials;
- iii) to depute its officer/officers to watch the proceedings at any meeting of the Board of Directors or its committee. The deputed officer may be given an opportunity to be heard at

such meetings. He may also be required to send a report of the proceedings to the Reserve Bank:

- iv) to appoint its officer/officers to observe the manner in which the affairs of the banking company or its offices or branches are being conducted and to make a report thereon; and
- v) to require the banking company to make within specified time the changes in the management as pointed out by the Reserve Bank.

2.15 RESERVE BANK'S POWER TO CONTROL ADVANCES

Section 21 confers wide powers on the Reserve Bank to issue directives to the banking companies to determine the policy in relation to advances to be followed by the banking companies either generally or by any of them in particular. Before the Social Control Scheme, the Reserve Bank was authorised to do so in the interest of the depositors or in public interest but the Amending Act of 1968 added another consideration, i.e. the banking policy. The term banking policy is defined as “any policy which is specified from time to time by the Reserve Bank in the interest of the Banking system or in the interest of monetary stability or sound economic growth, having due regard to the interest of the depositors. The volume of deposits and other resources of the bank and the need for equitable allocation and efficient use of these deposits and resources. “The term banking policy is much wider in coverage and significance. The powers of the Reserve bank to issue directives under this Section have been widely enhanced.

Sub-section (2) of Section 21 specified the nature and scope of the directives the Reserve Bank may issue under this section. The directions may relate to any or all of the following:

- a) the purposes for which advances may or may not be made;

- b) the margins to be maintained in respect of secured advances;
- c) the maximum amount of advance to any one company, firm, individual, or association of persons. In determining such maximum amount the paid-up capital, reserves and deposits of the banking company and other relevant considerations will be taken into account:
- d) the maximum amount up to which guarantees may be given by the banking company on behalf of any one company, firm, etc.; and
- e) the rate of interest and other terms and conditions on which advances and other financial accommodation may be made or guarantees may be given.

When the policy is determined by the Reserve Bank of India in relation to advances, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy so determined. The Reserve Bank has exercised its powers under this Section quite frequently and has issued directives which are called selective credit control directives. The main objective of such directives has been to control credit granted by banks in order to check speculation and rising prices.

2.16 MANAGEMENT OF BANKING COMPANIES

The Banking Regulation Act contains a number of Sections which aim at ensuring better management of banking companies and confers wide powers on the Reserve Bank in this regard. The Social Control Scheme envisaged radical reforms at the top managerial level because in the considered opinion of the Government the link between a few industrial houses and the banks had to be snapped or at least made ineffective. The

Banking Laws (Amendment) Act, 1968, regarding the constitution of the Board of Directors and appointment of the Chairman.

(A) Constitution of the Board of Directors- Section 10A prescribes the eligibility of persons who may be appointed as directors. Every banking company is required to constitute its Board of Directors in such a way that not less than 51% of the total number of members of the Board shall consist of persons who satisfy the following two conditions:

(i) They have special knowledge or practical experience in respect of one or more of the following matters, namely, accountancy, agriculture and rural economy, banking, co-operation, economics, finance, law, small-scale industry or any other matter which, in the opinion of the Reserve Bank, would be useful to the banking company. It is also provided that out of the above number of directors not less than two shall have knowledge or practical experience in respect of agriculture and rural economy, co-operation and small-scale industry; and

(ii) they do not have substantial interest in or be connected with (as employee or manager) any company or any firm which carries on any trading, commercial or industrial concern. This qualification does not apply to those who are proprietors of or are substantially interested in a small-scale industry or a company registered under Section 25 of the Companies Act, 1956.

The term 'substantial interest' has been defined in the Act. In relation to a company it means the holding of beneficial interest by an individual or his spouse or minor child, whether single or taken together in the shares of the company, the amount paid-up on which exceeds Rs. 5 lakh or ten per cent of the paid-up capital of the company whichever is less. In case of a firm, substantial interest means the beneficial interest held therein by an individual or his spouse or minor child, whether

singly or taken together which represents more than 10 per cent of the total capital subscribed by all the partners of the firm. It is significant to note that the beneficial interest of the spouse and minor child is also taken into account either singly or together with that of the individual in both these cases. This provision thus limits the association of big businessman and requires the appointment as directors of experts in accountancy, law, finance, banking and representatives of the hitherto neglected but deserving sectors of the economy like agriculture, small-scale industry and co-operation.

If the above requirements are not fulfilled at any time in respect of any banking company, the Board of Directors shall reconstitute the Board so as to ensure that the above requirements are fulfilled. The Board may retire, if necessary, any director or directors for this purpose by draw of lots in the prescribed manner.

If the composition of the Board of Directors does not fulfil the above requirements, the Reserve Bank may direct the banking company to reconstitute its Board and if the banking company does not comply with such directions within two months the Reserve Bank may itself remove a director/directors and appoint a suitable person/persons in his/their place. The person/persons appointed by the Reserve Bank shall be deemed to have been duly elected by the banking company.

According to sub-section 2A, inserted in 1983, a director of a banking company, other than its Chairman or whole-time director, shall not hold office continuously for a period exceeding eight years. If the Chairman or other whole-time director of a banking company is removed from office as Chairman/whole-time director, he shall also cease to be a director. He shall not be eligible to be re-appointed as director of such banking company for a period of 4 years from the date of his ceasing to be the Chairman whole-time director.

Prohibition of common directors- Section 16 prohibits a banking company incorporated in India from having as a director any person who is a director of any other banking company. Similarly, a person who is a director of companies, which among themselves are entitled to exercise voting rights in excess of 25 per cent of the total voting rights of all the shareholders of the banking company, he cannot be appointed as a director of the banking company. These prohibitions are not applicable to persons appointed as directors by the Reserve Bank. This Section does not apply to banking companies incorporated outside India.

(B) Appointment of Chairman- Section 10B provides that every banking company shall have one of its directors as the Chairman of its Board of Directors who shall be entrusted with the management of whole of the affairs of the banking company but he shall exercise his powers subject to the superintendence; control and direction of the Board of Directors. The Chairman is required to be in the whole-time employment of the banking company. He shall hold office for such period, not exceeding 5 years as the Board may fix. He shall be eligible for re-election or re-appointment.

Sub-section (4) prescribes that a Chairman shall be a person who has special knowledge and practical experience of the working of a banking company or the State Bank of India or its subsidiaries or a financial institution or that of financial, economic or business administration. A person shall be disqualified for appointment as Chairman if he-

- i) is a director of a company other than a subsidiary company of the banking company or a company registered under Section 25 of the Companies Act, 1956; or
- ii) is a partner of any firm which carries on any trade, business or industry; or

- iii) has substantial interest in any other company or firm; or
- iv) is a director, manager, partner or proprietor of any trading, commercial or industrial concern; or
- v) is engaged in other business or vocation.

The above provisions of the Act intend to approve the appointment of a person with professional experience in banking, economic or business organisations without having interest in any other company or firm in the capacities mentioned above. The election or appointment of the Chairman must be to the satisfaction of the Reserve Bank. If the Reserve bank is authorised to remove the said person from the office of Chairman and to appoint a suitable person in his place. Such person shall hold office for the rest of the period of office of his predecessor. The displaced Chairman or the banking company concerned may prefer an appeal to the Central Government against the decision of the Reserve Bank.

The Reserve bank may permit the Chairman to undertake such part-time honorary work as is not likely to interfere with his duties as Chairman. Director or Chairman appointed by the Reserve bank under Section 15A or 15B, respectively, shall not be required to hold qualification shares in the banking companies. Sections 10C and 10D prohibit any person removed by the Reserve Bank under the above Sections from claiming any compensation for loss or termination of office. Prohibition of common directorship in more than one banking company in respect of a director appointed by the Reserve Bank has also been scrapped to enable the Reserve Bank to find suitable persons for appointment as directors.

Reserve Bank's control over top management of banks

Section 12A confers on the Reserve Bank the power to require any banking company to call a general meeting of the shareholders of the company within the prescribed time to elect, in accordance with the voting rights permissible under the Act, fresh directors. The banking company shall be bound to comply with such order. The directors thus elected will continue in office for the unexpired period of office of his predecessor.

Section 35B requires every banking company to take prior approval of the Reserve Bank for the appointment, re-appointment or termination of the appointment of a chairman, a managing or wholetime director, manager or chief executive officer. Approval of the Reserve Bank is also necessary for amending any provision relating to such appointment, reappointment, termination of appointment of a chairman, managing director or any other director or of a manager or a chief executive officer. Such provision may be contained in the company's Memorandum or Articles of Association or in an agreement entered into by it or in any resolution passed by the company in general meeting or by its board of directors.

Section 36AA confers upon the Reserve Bank the power to remove the top managerial personnel of the banking companies. The Reserve Bank may remove from office chairman, director, chief executive officer or any other employee of the banking company for reasons which are to be recorded in writing with effect from a date specified in the order. Such a removal may take place if the Bank feels it necessary in the public interest or for preventing the affairs of a banking company being conducted in a manner detrimental to the interest of the depositors or for securing the proper management of any banking company. But the person concerned will be given a reasonable opportunity for making a representation against such order. However, the Reserve Bank may

direct the person concerned not to act in a particular capacity and not to be concerned with the management of the banking company while his representation is being considered by the Reserve Bank. He may prefer an appeal to the Central Government within 30 days. The decision of the Central Government shall be final.

The person against whom the above-mentioned order is passed shall cease to be the chairman or officer, director or employee, as the case may be, and shall not, in any way, whether directly or indirectly, be concerned with or take part in the management of any banking company for a period not exceeding five years. If any such person contravenes the provisions of this Section, he shall be punishable with fine up to Rs. 250 for each day during which such contravention continues. The person removed under this Section shall not be entitled to claim any compensation for the loss or termination of office.

Under section 36AA(6), the Reserve Bank may appoint a suitable person in place of the person removed from office with effect from the date specified in such order. Such person shall hold office during the pleasure of the Reserve Bank for a period not exceeding three years, which may be extended further by another period of three years at a time. He will not incur any obligation or liability for being on his post or for anything done or omitted to be done in good faith in the execution of the duties of his office.

Under Section 36AB, the Reserve Bank may appoint one or more persons to hold office as additional directors of a banking company if it deems necessary in the interest of banking policy or in the public interest or the banking company or its depositors. The number of such additional directors shall not at a time exceed 5 or one-third of the maximum strength of the Board, whichever is less. Such director shall not be required to hold qualification shares in the banking company and shall

hold office at the pleasure of the Reserve Bank and shall not incur any obligation as mentioned above.

Section 36AC lays down that the appointment or removal of any person in pursuance of Sections 36AA and 36AB shall have effect, notwithstanding anything to the contrary contained in the Companies Act, 1956, or any other law for the time being in force or in any other instrument.

2.17 SUMMARY

Banks are financial intermediaries and they are primarily engaged in deposits mobilisation, lending and investment as per the definition of banking given in the Banking Regulation Act, 1949. The Act is divided into five parts. While the main provisions relating to a banking company as a going concern are contained in Parts I, II, IIA, IIB and IIIB, the miscellaneous and provisions applicable to co-operative banks are contained in parts IV and V respectively. The various provisions of the Act are available in its sections 1 to 56. After nationalisation of major banks in India, all the provisions of the Banking Regulation Act do not apply to the nationalised banks. However, Sections 5, 6, 10, 13 to 15, 17, 19 to 21, 23 to 28, 29 (exclusive of such section 1), 36 AD, 46 to 48, 50, 52 and 53 are applicable to the nationalised banks as well.

2.18 KEYWORDS

Banking Regulation Act: Before 1949, the Indian Companies Act, 1913, contained special provisions relating to banking companies, which were felt inadequate and were subsequently incorporated in the comprehensive legislation passed in 1949 under the name of Banking Companies Act, 1949. Since its enforcement in 1949, this Act was suitably amended a number of times to insert new provisions and to

amended the existing ones to suit the needs of changing circumstances and to plug the loopholes in the main legislation. The most significant amendment of the Act was effected by the Banking Laws (Amendment) Act, 1968, which introduced 'Social Control' on banks by inserting regulatory provisions of far-reaching significance.

Banking: Banking is defined as 'accepting, for the purpose of lending or investment, or deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise' [Section 5(b)].

CRR: The scheduled banks as they are required to maintain similar cash reserve with the Reserve Bank of India under Section 42 of the Reserve Bank of India Act, 1934.

SLR: Every banking company is required to maintain in India in cash, gold or unencumbered approved securities an amount which shall not at the close of business on any day be less than 25 per cent of the total of its net demand and time liabilities in India. This is called the Statutory Liquidity Ratio (SLR).

2.19 SELF ASSESSMENT QUESTIONS

1. Critically analyse the provisions of the Banking Regulation Act, 1949, with regard to (a) Branch Expansion, and (b) Licensing of Banks in India.
2. State the provisions of the Banking Regulation Act, regarding licensing of banking companies and minimum paid-up capital and reserves.
3. Mention the various kinds of returns a scheduled bank has to submit periodically to the Reserve Bank of India and

discuss their significance from the Reserve bank's point of view.

4. Describe the powers that are vested in the Reserve Bank of India for the control and regulation of banks under the Banking Regulation Act, 1949.
5. Discuss the main powers of the Reserve Bank of India under the Banking Regulation Act, 1949.
6. What are the powers granted to the Reserve Bank of India under the Banking Regulation Act, 1949, to regulate the development of banking?
7. Discuss the ways in which the Reserve Bank of India exercises control and supervision over the loans and advances of commercial banks. Has its control effective in recent years? If not, why?
8. Attempt a brief review of the working of the Banking Regulation Act, 1949. How far, in your view, has banking regulation in India contributed to the growth and development of banking in the country?
9. Explain the provisions of the Banking Regulation Act 1949, relating to the preparation of accounts and Balance Sheet by a banking company.
10. State the important provisions of the Banking Regulation Act regarding- (a) Liquidity; (b) Branch expansion; and (c) Reserves.

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Subject: **Principles of Insurance and Banking**

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Lesson: **3**

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Banker-Customer Relationship

STRUCTURE

- 3.0 Objectives
- 3.1 Introduction
- 3.2 Definition of banker
- 3.3 General Relationship between Banker and Customer
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3.0 OBJECTIVES

After reading this lesson you should be able to-

- Define and distinguish the term banking from any other commercial institution;
- Define the term 'customer' of bank;
- Understand the general relationship between banker and customer; and
- Know the special features of the relationship between banker and customer.

3.1 INTRODUCTION

Banks and financial institutions (FIs) are in the process of great change in the context of the ongoing financial sector reforms and the emerging competitive financial system within and outside the country. With the widening and deepening of markets for long-term funds, the justification for further prolonging the role of subsidized credit from banks and FIs has weakened; more so because prolonged concessional finance by the Government has been deemed to be neither sustainable nor desirable. This is consistent with the process of financial sector reforms, with its focus on allocative efficiency and stability. With the withdrawal of concessional sources of finance of banks and FIs and blurring of distinction between FIs and banks, FIs not only have to raise resources at market-related rates but also have to face a competitive environment on both asset and liability sides. Moreover, structural changes in the financial system coupled with the industrial slowdown in recent years have adversely affected the volume of business and profitability of FIs.

Banks are becoming increasingly complex organisations. Investors are finding it harder to understand the quality of financial performance and risk exposures of banks. The traditional set of information as contained in banks' balance sheet often fails to convey information to readers of financial statements that can enable them to ascertain the quality of earnings. Accordingly, supervisors world-wide are making conscious efforts towards increasing the quality and quantity of disclosures in banks' balance sheets. Transparency challenges are met where market participants not only provide information, but also place the information in a context that makes it meaningful to accurately reflect risks. The quest for transparency has, therefore, to be continuous and persistent.

Increasing competition among banks, emanating not only from peers, but also from new entrants and other intermediaries, has been exerting pressure on bank spreads. The technology-intensive new private and foreign banks are positioning themselves as 'one-stop-shop' financial services and providing customers greater convenience and high quality services backed by appropriate investments in technology and other infrastructure. Therefore, the future profitability of public sector banks would depend on their ability to generate greater non-interest income and control operating expenses. Blue-chip clients continue to have the option to raise low-cost funds directly from domestic and international markets. The reforms-supported new environment is offering depositors and borrowers a wider range of opportunities to transact their business. Apart from the applicability of capital adequacy standards being in force, new methods of measuring market risk such as value-at-risk and pre-commitment approaches are expected to provide a more standardized but tighter framework for the banking sector. Simultaneously, the banking industry is undergoing a change driven by technological advancements. Since retail customers are fast becoming more demanding, in the competitive environment, banks have to offer the value-added services. Harnessing technology to improve productivity so as to produce highly competitive types of banking and generating greater non-interest income by diversifying into non-fund based activities will be important features of the Indian banking of tomorrow.

In view of this changed environment, banks FIs are in the process of adjusting business relationship with their customer. The bank-customer relationship is an emerging area that has attracted the attention of many stakeholders in this regard. Before we take up the relationship that exists between a banker and his customer, let us understand the definitions of the term's 'banker' and 'customer'.

3.2 DEFINITION OF BANKER

There has been much controversy regarding the definition of the term “banker”. The essential function of a banker is the acceptance of deposits of funds with drawable on demand. Section 5(a) of the Banking Regulation Act defines banking company as a company, which transacts the business the business of banking. In order to understand the nature of a banking company, one will have to look into the definition of the term ‘banking’. In simple words it can be defined as trading in money and instruments of credit. According to section 5(b) “Banking means the accepting for the purpose of lending or investment of deposit of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise”.

Sir John Paget another well-known authority on banking, considers that “no person or body, corporate or otherwise, can be a banker who does not (1) Take deposits accounts (2) Take current accounts (3) Issue and pay cheques and (4) Collect cheques crossed and uncrossed for his customers.”

Besides Sir Paget maintains that a banker should progress himself to be a banker and the public should accept him as such. Banking should be his main source of income.

According to section 7 of the Banking Regulation Act, 1949, “No company other than a banking company shall use as part of its name any of the words ‘bank’, ‘banker’ or ‘banking’ and no company shall carry on the business of banking in India unless it uses as part of its name at least one such. The functions of a banker are: -

- Accepting of deposits
- Lending of money

- Undertaking to honor cheques drawn upon it by customers and
- To work in the capacity of an agent etc.

The service of a modern banker is different. These additional functions can be grouped under two broad heads (a) Agency service (b) general utility services. The agency services comprise of payment and collection of cheques, bills, promissory notes, salary and pension bills, purchase and sale of stock and share, etc. The general utility services of the banker include the issue of credit instruments, letters of credit, traveler cheques, transactions of foreign exchange, acceptance of valuable and documents for safe custody, provision of facilities for safe deposit lockers, administration of estates as trustees, executors etc.

Now a bank can be distinguished from any other commercial institutions on the basis of the following features: -

- A. Deposit Accounts:** The bank receives deposits from the public in the form of saving accounts, fixed deposit accounts, recurring deposit accounts pigmy deposit accounts etc.
- B. Current Accounts:** The bank receives deposits on current accounts from the businessperson. A current account is a running account. There is no limit on the number of times the account holder can withdraw his money.
- C. Cheque Facility:** The saving and current account holders enjoy the cheque facility. They can withdraw money by drawing cheques on their bank. The saving account holders who don't enjoy cheque facility can withdraw money with the help of withdrawal slips. It may be noted that the account holder may issue a cheque in favour of any person. The bank will honor it if there is sufficient balance in the account.

Meaning of a customer: Law does not define the term 'customer' of a bank. Ordinarily a person who has an account in a bank is considered its customer. In chambers dictionary, it is written, "A customer is one who is accustomed to frequent a certain place of business."

According to Dr. Hart, "A customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such."

Therefore, neither the number of transactions nor the period during which business has been conducted between the parties is material in determining whether a person is a customer. The accepted position at present recognizes a customer as one who satisfies the following conditions: -

1. **Duration not of essence:** The duration of dealing is not of essence. Even a single transaction can constitute a customer.
2. **Frequency anticipated:** Although frequency of transactions is not essential to constitute a person as customer, still his position must be such that transactions are likely to become frequent.
3. **Dealings to be of banking nature:** He should have dealing with the bank, which should be in the nature of regular banking business. That is, the person should have some type of account with the bank-either deposit, current or loan account. A person having dealings with the bank only in respect of its utility service viz. Safe deposit lockers, safe custody, remittances etc. does not constitute a customer.
4. **Introduction necessary:** The banker must have taken due care to satisfy him about the bonfides and repeatability of the customers. This is necessary to institute the persons as

customers for the purpose of protection of the banker under Negotiable Instruments Act.

- 5. Commencement of relation of from first transaction:** As soon as the banker accepts money from any person on the footing that he will honor his cheques upto the amount standing to his credit, the person becomes his customer. The money accepted can even be by way of cheque. The relation of banker and customer begins as soon as the first cheque is paid in and accepted for collection and not merely the it is paid

3.3 GENERAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER

The relationship between a banker and his customer is basically contractual. It is regulated by:

- The general rules of contract
- The rules of agency where applicable
- Banking practice.

Of the several possible relation ships between a banker and his customer, the primary one is that of debtor and creditor. But who is what at a particular moment depends on the state of customer's accounts. If the account shows a credit balance, obviously the banker is a debtor and the customer a creditor. Reverse shall be the position when the customer's account shows an overdrawn. Then there are three are tree possible other relationships depending upon the receptive state of circumstances, viz.,

- Bailor and bailee
- Principal and agent and
- Trustee and beneficiary.

Debtor and creditor relationship: The general relationship between a banker and his customer is basically that of debtor and creditor. If the account shows a credit balance, the banker will be a debtor and the customer a creditor. But in case of debit balance or overdraft, the banker will be the creditor and the customer the debtor. When the customer deposits money in the bank by opening an account, it amounts to lending money to the banker. The bank can make use of this money as it is absolutely at the disposal of the bank. The bank undertakes to repay the amount on demand. It has been rightly said that a banker is normally a debtor of his customer and is bound to discharge his indebtedness by honoring his customer's cheque. One important point to be understood in this connection is that the banker is not bound to pay the customer unless demand is made. However, when the demand is made, the bank can pay the amount deposited by the customer in any kind of notes and coins, thus a bank is not a mere depository of trustee. The banker only undertakes to pay a sum equivalent to the amount deposited with him and the customer has no right whatsoever to claim the identical coins or notes deposited with him.

The usual debtor-creditor relationship between a banker and a customer is governed by the following conditions, which are not applicable to similar commercial debts:

1. Demand for Payment: A bank is not an ordinary debtor in the sense that it is under no obligation to refund the customer's deposits unless demand is made. Even in case of fixed deposit the bank is not required to return the money on its own accord. The customer must make a demand for repayment of funds deposited except when the bank is being wound up.
2. Proper place and time: The obligation to repay the amount deposited is limited to the branches where the account is

kept. The customer can issue cheques only on the branch of the bank where the account is kept. The demand for payment must be made during the working hours and on working days of the branch concerned.

3. Demand in proper manner: The demand for payment should be made in proper manner as allowed by the law or custom. The demand should not be made verbally or through a telephonic message. The proper manner may be cheque; draft or anything, which may prove the genuineness of demand by the customer whose identity, must be disclosed and authenticated to the satisfaction of the bank.
4. No time bar: The depositor with a bank does not become time barred on the expiry of three years as in the case of other commercial debts. This is because of the reason that the amount does not become due unless it is demanded.

Banker as a trustee: The banker assumes the position of trustee when they accept securities or valuables from the customer for safe custody. The articles deposited with the bank for safe custody continue to be owned by the customer. The banker is to deal with the articles as per the instructions of the customer. The banker is a trustee of the customer in respect of cheques and bills deposited by the customer for collection till they are collected. He becomes the debtor once it is collected and credited to the account of the customer. If the bank is liquidated before the cheque is realized the bank remains a trustee of the customer. Therefore, the customer can claim back the cheque or the proceeds of the cheque in full.

Banker as agent: A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customer.

For example: some banks have established tax service departments to take up the tax problems of their customers.

Bailee and bailor: Another relation between the banker and the customer is that of bailee and bailor. The bank functions as bailee when it keeps valuable articles, diamond, gold, securities and other documents of its customers. The bank works, as the custodian of these things and it is implied responsibility of the bank to return these things safely. Thus the bank is a bailee and the customer is a bailor or beneficiary.

3.4 SPECIAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER

The relationship between the banker and the customer creates certain obligations on the part of the banker. These obligations alongwith the rights of the banker create special relationship. The various special features of the relationship are detailed below:

1. Banker has an obligation to honor the cheques of the customer up to the amount standing to the credit of the customer's account.
2. The banker has to maintain the secrecy of his customer's account.
3. The banker can charge interest all compound rates for defaults in payments of loan by the customer or for overdrawn amounts.
4. Banker is allowed to produce certified copies of the entries made in the original books of account as proof of transaction in legal proceedings under certain circumstances and cases in accordance with the provisions of banker's book evidence act, 1891.

5. A banker is under the obligation of law to suspend the operation of accounts by the customer in case of receipt of garnishee order from the court.

Obligations of a banker: Though the primary relationship between a banker and his customer is that of a debtor and creditor or vice-versa the special features of this relationship as noted above impose the following additional obligations on the banker:

1. **Obligation to honor the cheques:** Section 31 of Negotiable Instrument act, 1881 imposes upon bank the obligation to honor the cheques. The text of the act is as follows:
“The drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheques must pay the cheque when duly required so to do and in default of such payment must compensate the drawer for any loss or damage caused by such default.”
2. **Time and Place of Payment:** The demand of payment by the creditor must be made to the debtor at the proper place and in proper time. Transactions in the banks are carried out up to 2 p.m. on working days and up to 12 noon on every Saturday. A commercial bank, having a number of branches is considered to be one entity but the depositor enters into relationship with only that branch where an account is opened in his name.
3. **Demand made in proper order:** The statutory definition of banking system explains that deposits are withdrawn by cheque, drafts, order or otherwise. This is to be done as per the common usage amongst the bankers.

Cases in which the Banker Refuses Customer's Cheques

- (A) When may a banker refuse to honour a customer's cheque?

- When the balance to the credit of the customer not sufficient to meet the cheque.
 - When money deposited by the customer cannot be withdrawn on demand e.g., fixed deposits.
 - When the cheque is state i.e. it has become older than six months and has not been presented for payment with in reasonable time of the date of the issue.
 - When the account is in joint names and all the persons have not signed the cheque.
- (B) When the banker must reuse to honour customer's cheques:
- When the customer has stopped the payment of the cheque.
 - When the banker is served with "garnishee order" or a prohibitory order by any court.
 - When the bank comes to know of the defect in the title of the person presenting the cheque before the bank.
 - When the holder of the cheque gives a notice of its loss to the bank.
 - When the cheque is post-dated and is presented for payment before its ostensible date.

Garnishee Order: A garnishee order INS an order issued by the court under order 21 rules 46 of the code of civil Procedure, 1908, generally served on banks. Such order prohibits a banker from making payments from a particular a particular account named therein. When a debtor does not repay the debt owed by him to his creditor, the latter may apply to the court for the issue of a Garnishee Order on the banker of his debtor. Such order attaches the debts not secured by a negotiable instrument. The important features of a garnishee order are as under the order attaches either the entire deposit or a specified sum.

It attaches only the balance in the account at the time the order is received. Cheques etc. are sent for collection and the amounts deposited by the customer after the order is received are not attached. However, uncleared effects already placed to customer's credit are attached.

A Garnishee order is issued in two parts. In the first instance the court issue an order, called order nisi directing the banker to stop payments from the accounts of the judgement-debtor. The banker is also required to submit explanation, if any, as to why the funds in the said account should not be utilised for meeting the claim or the judgement. After the receipt of order nisi, the banker stops all payments from the said accounts and informs his customer accordingly.

3.5 RIGHTS OF BANKER

1. Right of "Set off or the right to combine accounts": A banker can combine two or more accounts of a customer and show the net balance as the amount due to from him.
2. Banker's General Lien: The banker has a right of general lien against the customer; the right to retain as security for a general balances of accounts any goods and securities bailee to him.
3. Right of Application: Where customer has not directed the bank to appropriate a deposit against a particular debt, it is the bank's right to appropriate the Payment to any debt.
4. Law of Limitation: Under article 22 of part 2 of the schedule to the limitation act 1963 the period of limitation for the refund of bank deposits is three years from the date the customer demand repayment.

3.6 TERMINATION OF RELATIONSHIP

The relationship of a banker and customer may be terminated in any of the following ways:

1. Mutual Agreement: This is clear enough. The balance at the credit of the customer will have to be paid off and the overdraft, if any cleared.
2. Notice to Terminate: In case of a current account, no such notice appears necessary. But if it's a deposit account, the banker could insist on the notice period specified on the fixed deposit.
3. Death of Customer: This is an obvious method of terminating the relationship. But it is the notice of death, which revokes the banker's authority to pay cheques.
4. Lunacy of Customer: The lunacy of a customer automatically terminates relationships though here again the banker's authority to pay cheques is revoked by notice of insanity.
5. Bankruptcy: Bankruptcy or winding up is a sufficient ground for terminating the relationship. The customer will be entitled to a dividend in respect of any balance standing to the credit of his account calculated in the ordinary ways and will be entitled to the return of any articles bartered.

3.7 SUMMARY

The traditional functions of a banker are accepting of deposits and landing of money. But the services of a modern banker also include agency services and general utility services. These services comprise of payment and collection of cheques, bills, promissory notes, salary and pension bills, issue of credit instruments, letter of credit, etc. A customer is one who has an account with a banker.

The relationship between a Banker and his customer is contractual and is regulated by general rules of contract, the rules of agency and

banking practices in vogue. The general relationship between a banker and his customer is basically that of debtor and creditor. If the account shows a credit balance, the banker is debtor and the customer a creditor. The vice versa is true in case of a debit balance.

3.8 KEYWORDS

Banker: Section 5(a) of the Banking Regulation Act defines banking company as a company, which transacts the business the business of banking. In order to understand the nature of a banking company, one will have to look into the definition of the term 'banking'.

Banking: According to section 5(b) "Banking means the accepting for the purpose of lending or investment of deposit of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise".

Customer of a bank: A customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such.

Garnishee order: A garnishee order INS an order issued by the court under order 21 rules 46 of the code of civil Procedure, 1908, generally served on banks. Such order prohibits a banker from making payments from a particular a particular account named therein. When a debtor does not repay the debt owed by him to his creditor, the latter may apply to the court for the issue of a Garnishee Order on the banker of his debtor. Such order attaches the debts not secured by a negotiable instrument.

Banker as a trustee: The bankers assumes the position of trustee when they accepts securities or valuables from the customer for safe custody. The articles deposited with the bank for safe custody continue to be owned by the customer. The banker is to deal with the articles as

per the instructions of the customer. The banker is a trustee of the customer in respect of cheques and bills deposited by the customer for collection till they are collected.

3.9 SELF ASSESSMENT QUESTIONS

1. “Bankers who happen to be more alert on relationship front are likely to succeed in modern times.” Explain the statement and elaborate the future of bank-customer relationship in India.
2. Explain and illustrate the nature and types of bank-customers relationship in India. What is the Garnish Rule in this connection.
3. Write short notes on the following:
 - (a) Rights of the banker
 - (b) Termination of bank-customer relationship

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Lesson: **4**

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Modes of creating charge

STRUCTURE

- 4.0 Objectives
- 4.1 Introduction
 - 4.2 Modes of creating a charge
 - 4.2.1 Lien
 - 4.2.2 Pledge
 - 4.2.3 Hypothecation
 - 4.2.4 Mortgage
- 4.3 Summary
- 4.4 Keywords
- 4.5 Self assessment questions
- 4.6 References/Suggested readings

4.0 OBJECTIVES

After reading this lesson, you should be able to-

- Understand how the banks ensure safety of the funds advanced by them;
- Know about the legal provisions regarding the modes of creating charge over the tangible assets;

Describe the rights and duties of a banker as a pledgee, unpaid seller and mortgagee.

4.1 INTRODUCTION

A sound banking is based on safety of funds lent by a banker to his customers. A banker lends his funds to persons of means, engaged in some business, trade, industry or in any profession or vocation. The first and the most important criterion to judge safety of funds is the capacity of the borrower himself to repay the amount of the loan after having achieved success in the productive activity for which the loan is taken. The banker, therefore, relies primarily on the character, capacity and capital of the borrower in ensuring the safety of his funds. The viability of the project and the honesty and capability of the borrower ensure to a large extent the safety of funds lent by the banker.

Secured advances are those advances, which provide absolute safety to the banker by means of a charge created on the tangible assets of the borrower in favour of the banker. In such cases, the banker gets certain rights in the tangible assets over which a charge is created.

4.2 MODES OF CREATING A CHARGE

There are several modes of creating a charge, e.g., lien, pledge, hypothecation and mortgage.

4.2.1 Lien

The Indian Contract Act confers the right of general lien on the banker (Section 117). The banker is empowered to retain all securities of the customer, in respect of the general balance due from him. The ownership of such securities is not transferred from the customer to the banker. The latter gets the right to retain the securities handed over to him in his capacity as a banker. A banker's lien is considered tantamount to an implied pledge and he gets the right to sell the securities in certain circumstances.

Negative Lien- Negative lien is to be distinguished from lien. Under the negative lien, the banker does not get the right to retain any asset of the borrower. The borrower gives a declaration to the banker that his assets mentioned therein are free from any charge or encumbrance. He also gives an undertaking that he shall not create any charge over them or dispose them of without the permission of the banker. The borrower cannot dispose of the assets or create any charge thereon without the consent of the banker. The banker, on the other hand, is not entitled to realise his dues from the said assets of the customer. His interests are thus partly safe by securing a negative lien.

4.2.2 Pledge

According to section 172 of the Indian Contract Act, 1872 pledge is defined as “bailment of goods as security for payment of a debt or performance of a promise”. The person who offers the security is called the 'pawner' or 'pledger' and the bailee is called the 'pawnee' or the 'pledgee'. Thus, in case of a pledge-

- (i) there should be bailment of goods; and
- (ii) the objective of such bailment should be to hold the goods as security for the payment of a debt or the performance of a promise. In other words, the bailment should be on behalf of a debtor or an intending debtor.

1. Bailment of goods- Section 148 defines bailment as the “delivery of goods from one person to another for some purpose upon the contract that the goods be returned back when the purpose is accomplished or otherwise disposed of according to the instructions of the bailor”.

2. Bailment of security for payment of debt- It is essential that the bailment of the goods is done with the object to secure the

payment of a debt or the performance of a promise. If the goods are left with the banker for safe custody or for any other purpose, it does not constitute a pledge. Banks, therefore, take a declaration in case of pledge to safeguard their interests.

Who can pledge the goods?

Goods can be pledged by any one who is in legal possession of the same, namely,

1. The owner of the goods himself.
2. The mercantile agent of the owner- According to Section 178, “where a mercantile agent is, with the consent of the owner, in possession of goods or the documents of title to goods, any pledge made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorised by the owner of the goods to make the same, provided that the pawnee acts in good faith and has not, at the time of pledge, notice that the pawner has no authority to pledge”.
3. Joint-owner with the consent of other co-owner- If the interest of the pledger in the goods is to a limited extent only, he can pledge the same to the extent of his limited interest. But in such cases the rights of an innocent third party are well protected, if a second pledge is made to him.
4. If a person obtains possession of the goods by fraud, misrepresentation, coercion or undue influence, such contract is voidable at the option of the lawful owner. However, the former can create a valid pledge on such goods provided the following conditions are fulfilled:
 - (a) The contract has not been rescinded before the contract of pledge is entered into.

- (b) The pledgee acts in good faith and without notice of the defective title of the pledger.
5. If a buyer leaves the goods or documents of title to goods after sale in the possession of the seller, the latter may make a valid pledge of the goods provided the pledgee acts in good faith and he has no notice of the sale of goods to the buyer.

Rights of a banker as a pledgee

1. The pledgee has the right to retain the goods pledged for the payment of the debt or the performance of the promise and also for the amount of interest due on the debt and the necessary expenses incurred by him in connection with the possession or for the preservation of the goods pledged (Section 173). This right is applicable only in case of particular debt for which the goods are pledged, in the absence of an agreement to the contrary (Section 174). The pledgee can also claim any extra-ordinary expenses incurred by him for the preservation of the security.

The banker is entitled to this right of the pawnee in case of cash credit arrangements, even if the customer (pledger) has violated any provisions of the law in respect of the goods pledged.

This right of the pledgee is not affected even if he allows the pledger to retain possession over the goods pledged. In *Bank of India vs. M/s Binod Steel Limited and Another* (A.I.R. 1977 M.P. 188), the Bank of India permitted the company to retain possession of the movable machines pledged to it as security for loan, for and on behalf of the bank. Subsequently the Additional Tahsildar attached the movable machines for the recovery of the amount of wages due to the workers of the company. The High Court held that-

“The legal possession and custody of the machinery and other movables of the company, which were under a pledge, must be held to be in the bank itself. The physical possession may be with the company but in the eyes of law the company must be deemed to be in possession of the same for and on behalf of the bank, the pledgee”.

The court held that the bank was a secured creditor and since the right to possess the movables and machinery as pledgee was vested in the bank, no one could touch the pledged property until the claim of the bank was satisfied.

2. In case of default by the pledger to make payment of the debt, the pledgee has the right either-

(a) to file a civil suit against the pledger for the amount due and retain the goods as a collateral security; or

(b) to sell the goods pledged after giving the pledger reasonable notice of sale (Section 176).

The pledgee can resort to these steps only when the pledger defaults in making payment of the debt and not earlier. In case of loans repayable after a fixed period, default takes place if the loan remains unpaid after the expiry of the stipulated period. In case of a loan repayable on demand, default takes place if, on receipt of a notice from the creditor demanding the repayment of the loan by a specified date, the debtor fails to do so within the period allowed by the creditor.

The question whether the pledgee can exercise the right to sue and the right to sell the pledged goods or securities concurrently was decided in *Iaridas Mundra vs. National and Grindlays Bank* (67 G.W.N. 58). In this case the Bank, being the pledgee of the shares, filed a suit for the recovery of the loan. During pendency of the suit the Bank served a

notice on the customer demanding payment of its dues failing which the shares would be sold by the bank. The customer pleaded that the right of the pawnee under section 176 to sue for the debt or the promise is alternative to his right to sell and that he cannot sell the articles after he files a suit on the debt. The Court held that the right to retain the article pawned and the right to sell it are alternative and not concurrent rights. The pawnee has the right (i) either to sue on the debt or the promise concurrently with his right to retain the pawn or (ii) to sell it. However, the court observed that the institution of a suit upon the debt or promise does not reduce the pledge to a passive lien and destroy the pawnee's right to sell the article pawned and that right to sell is necessary to make the security effectual for the discharge of the pawner's obligation and the right continues in spite of the institution of the suit. This means that the banker is not denied the option for the second right, i.e., to sell, if he had already filed a suit in the Court. If he sells the goods after giving due notice and his claim is met in full, the suit filed becomes ineffective.

But the pledger cannot force the pledgee to sell goods without clearing debts even if value of the goods pledged deteriorated during the pendency (Bank of Maharashtra vs. M/s Racmann Auto (P) Ltd. (AIR 1991 Delhi 278). In this case, the Delhi High Court further held that if the value of the goods had deteriorated due to passage of time, no relief can be obtained by the pledger against the pledgee as the former was legally bound to clear the debt and obtain the possession of the pledged goods from the bank, before the pledged goods were sold during the pendency or the suit.

It is also essential that a clear and specific notice of sale is issued to the pledger before the pledgee exercises his right of sale, notwithstanding the presence of a specific term in the agreement of pledge authorising the pledgee to sell the security without notice to the pledger.

The sale made by the pledgee without giving a reasonable notice to the pledger cannot be set aside, but the pledgee will be liable to the pledger for the damages.

It must be noted that after giving notice of sale, the pledgee retains the right to sell or not to sell the goods pledged. It is not obligatory for him to sell the goods within a reasonable time after the notice of sale is served. If the sale proceeds are insufficient to meet the claim of the pledgee, the pledger remains liable to pay the balance. If the sale proceeds exceed the amount due, the pledgee has to return the excess amount to the pledger.

3. The pledger is bound to disclose to the pledgee the faults, if any, in the goods pledged which are within his knowledge, and which materially interfere with the use of those goods or expose the pledgee to extraordinary risks. If the pledgee suffers any damage as a result of non-disclosure of such fault by the pledger, the latter shall be responsible for it.

4. If the title of the pledger to the goods pledged is defective and the pledgee suffers any loss due to this fact, the pledger shall be responsible for such loss.

5. If the pledgee has given his consent as a result of inducement by fraud or misrepresentation in this regard or in regard to pledger's interest in the goods, the contract would be voidable at the option of the pledgee.

6. A pledgee's rights are not limited to his interest in the pledged goods but he would have all the remedies that the owner of the goods would have against a third person for deprivation of goods or injury to them. In *Morvi Mercantile Bank Ltd. Vs. Union of India*, the Supreme Court held that the bank (pledgee) was entitled to recover the

full value of the consignment from Railways, namely, Rs. 35,000 and not only the amount due to it from the customer, namely, Rs. 20,000.

Duties of the pledgee

1. The pledgee is bound to return the goods on payment of the debt. It is the duty of the pledgee to restore the goods to the pledger or to deliver the goods according to the directions of the pledger as soon as the obligation to repay the amount is discharged.

2. The pledgee is responsible to the pledger for any loss, destruction or deterioration of the goods, if the goods are not returned by the pledgee at the proper time (Section 161).

The banker remains liable to the pledger even if the goods are delivered to a wrong party without the negligence of the banker. In *UCO Bank vs. Hem Chandra Sarkar* (1991) 70 Comp. Case P119, S.C., the goods were delivered by the bank to some impostor who produced an artfully forged order. The Supreme Court held that a banker takes charge of goods, articles, securities etc., as bailee only and any inference of a fiduciary relationship was unwarranted and unjustified. It further held that if the property is not delivered to the true owner, the banker cannot avoid his liability in conversion. In its opinion, where the bank delivers the goods to the wrong person, whereby they are lost to the owner, the liability of the bank is absolute, though there is no element of negligence just as where delivery is obtained by means of an artfully forged order.

3. The pledgee is bound to use the goods pledged according to the agreement between the two parties. If he violates any of the conditions of the pledge, the contract would be voidable at the option of the pledger. He is also liable to make compensation to the pledger if he suffers any damage due to the unapproved use of the goods pledged (Section 153).

4. The pledgee is also bound to deliver to the pledger any increase of profit which may have accrued from the goods bailed in the absence of an agreement to the contrary (Section 163). In *M.R. Dhawan vs. Madan Mohan and Others* (A.I.R. 1969 Delhi 313), the borrower pledged certain shares with the banker. The right of the pledgee to the dividends and the rights and bonus shares issued in respect of pledged shares was disputed by the pledger. Declaring that the pledgee has no right, in the absence of a contract to the contrary, to the accretion to the goods pledged, the Delhi High Court observed that-

“The primary purpose of a pledge, which is a kind of bailment and security, is to put the goods pledged in the power of the pledgee to reimburse himself for the money advanced, when on becoming due it remains unpaid, by selling the goods after serving the pledger with a due notice. The pledgee at no time becomes the owner of the goods pledged. He has only a right to retain the goods until his claim for the money advanced thereon has been satisfied. The pledgee acquires a right, after notice, to dispose of the goods pledged. This amounts to his acquiring only a 'special property' in the goods pledged. The general property therein remains in the pledger and wholly reverts to him on the payment of the debt or performance of the promise. Any accretion to the goods pledged will, therefore, be, in the absence of any contract to the contrary, the property of the pledger”.

4.2.3 Hypothecation

Hypothecation is another method of creating a charge over the movable assets. Under hypothecation neither ownership nor possession of goods is transferred to the creditor but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so. The

charge of hypothecation is thus converted into that of a pledge and the banker or the hypothecatee enjoys the powers and rights of a pledgee. In *M/s Gopal Singh Hira Singh vs. Punjab National Bank* (A.I.R. 1976, Delhi 115), the Delhi High Court observed that in case of hypothecation, “The borrower is in actual physical possession but the constructive possession is still of the bank because, according to the deed of hypothecation, the borrower holds the actual physical possession not in his own right as the owner of the goods but as the agent of the bank”. The High Court, therefore, concluded that in law there was no difference between pledge and hypothecation with regard to the legal possession of the banks- the hypothecated goods are also not only constructively but actually in the possession of the bank. But to enforce its claim it is essential for the bank to take possession of the hypothecated property on its own or through the Court. The bank can enforce the security by filing a suit to this effect. If the banker fails to do so, and chooses to seek a simple money decree, the bank would be deemed to have waived its right as hypothecatee. In *Syndicate Bank vs. Official Liquidator, Prashant Engineering Co. Pvt. Ltd.* (1986) 59 comp. Cases 301, the Bank filed a suit for the recovery of money and failed to make a claim on the security. It was held that the Bank ranked as an unsecured creditor along with other creditors of the company.

Hypothecation is a convenient device to create a charge over the movable assets in circumstances in which transfer of possession is either inconvenient or impracticable. For example, if a borrower wants to borrow on the security of raw materials or goods-in-process, which are to be processed into finished products, transfer of possession will impede the functioning of the borrower’s business. By hypothecating such stocks, the borrower may use the same in any manner he likes, e.g., he may take out the stock, sell it and replenish it by a new one. A floating charge is thus created over the movable assets of the borrower on the

confidence reposed by the creditor. Hypothecation is thus only an extended idea of pledge; the creditor permitting the debtor to retain possession either on behalf of or in trust for himself. The creditor possesses the right of a pledgee under the Deed of Hypothecation.

According to a recent judgement of the Andhra Pradesh High Court it is open to the bank to take possession of the hypothecated property on its own or through the court as per the hypothecation agreement. Where there is any specific clause in the hypothecation agreement empowering the hypothecatee to take possession of the goods and sell the same in the event of default in payment, the Court (State Bank of India vs. SB Shah Ali: (Unreported judgement of High Court dated 9.3.94).

If the hypothecated vehicle is involved in an accident and the passengers of the other vehicle are injured, the bank will not be liable for the compensation to the victims. In Bank of Baroda vs. Babari Bachubhai Hirabhai and Others (A.I.R. 1987 Gujarat), the Gujarat High Court held that the hypothecating bank had no title over the vehicle, it had merely a right to recover its dues by the sale of that vehicle and so long as there was no default in the payment of the loan amount, it could not exercise that special right to sell the vehicle for the realisation of its dues.

The relative rights of unpaid seller and the hypothecatee

In case of Punjab National Bank vs. M/s Lakshmi Card Clothing and Manufacturing Ltd. And Another 1978 T.N. Law Notes Journal p. 89), the Madras High Court considered the question of relative rights of the unpaid seller and the bank as hypothecatee. In this case the manufacturer of textile machines sold to a textile mill some machinery on the condition that the transfer of the property in the goods was to take place only after the purchaser had paid full value thereof. The

purchaser failed to pay the full value and hence the seller wanted to take back the goods. But as all the movables in the mill of the purchaser were under hypothecation with the Punjab National Bank, the machinery could not be restored to the seller. The seller, therefore, filed a suit for the machinery or the payment of its price. The purchaser contended that the contract of sale has been repudiated and it was willing to return the items supplied by the manufacturer.

But the Punjab National Bank contended that the purchaser had obtained overdraft facilities from its Mount Road branch after executing deeds of hypothecation and pledge. As the goods stood transferred to the Bank, its charge over the same was protected under Section 30(2) of the Sale of Goods Act, 1930. The seller pleaded that the bank had the knowledge of the property in the goods not having passed to the buyer because the documents relating to the machinery were presented at its Mylapore branch.

Precautions to be taken by Banker- The position of the banker under hypothecation is not as safe as under a pledge. If the borrower fails to give possession of the goods hypothecated, or sells the entire stock or borrows from another banker on the security of the same goods, the banker shall have to resort to legal proceedings in a Court of Law for the recover of the amount lent. The advances on hypothecation basis are as risky as clean advances. The banker should, therefore, take the following precautions to safeguard his own position:

- (i) The facility of loans on the basis of hypothecation of goods should be sanctioned only to person or business houses of high reputation and sound financial standing.
- (ii) The banker must periodically inspect the hypothecated goods and the account books of the borrower should be checked to ascertain the position of stocks under

hypothecation. Care should be taken to see that unsaleable stocks are not being maintained by the borrower.

- (iii) The borrower should be asked to submit a statement of stocks periodically giving correct position about the stocks and its valuation and declaration that the borrower possesses clear title to the same.
- (iv) Stocks should be fully insured against fire and other risks.
- (v) A name plate of the bank, mentioning that the stocks are hypothecated to it, must be displayed at a prominent place in the business premises of the borrower for public notice. This is essential to avoid the risk of a second charge being created on the same stocks.

4.2.4 Mortgage

Section 58 of the Transfer of Property Act 1882 defines mortgage as “the transfer of an interest in specific immovable property for the purpose of securing the payment of money, advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”. The transferor is called ‘mortgagor’; the transferee ‘mortgagee’; the principal money and interest thereon, the payment of which is secured are called the ‘mortgage money’ and instrument if any, by which the transfer is effected is called a ‘mortgage deed’. The main characteristics of a mortgage are as follows:

1. A mortgage is the transfer of an interest in the specific immovable property and differs from sale wherein the ownership of the property is transferred. Transfer of an interest in the property means that the owner transfers some of the rights of ownership to the mortgagee and retains the

remaining rights with himself. For example, a mortgagor retains the right of redemption of the mortgaged property.

2. If there are more than one co-owners of an immovable property, every co-owner is entitled to mortgage his share in the property [Debi Singh vs. Bhim Singh and Others (A.I.R. 1971, Delhi 316)].
3. The property intended to be mortgaged must be specific (i.e., it can be described and identified by its location, size, boundaries, etc.). A mortgagor must mention which of his properties is intended to be mortgaged.
4. The object of transfer of interest in the property must be to secure a loan or to ensure the performance of an engagement which results in monetary obligation. Thus the property may be mortgaged to provide security to the creditor in respect of the loans already taken by the mortgagor or in respect of the loans which he intends to take in future. An existing overdraft can also be secured by the mortgage of the property. But if a person transfers his property for a purpose other than the above, it will not be called a mortgage, e.g., a transfer of property in discharge of a debt is not a mortgage.
5. The actual possession of the property need not always be transferred to the mortgagee.
6. The mortgagee gets, subject to the terms of the mortgage deed and the provisions of the Transfer of Property Act, 1882, the right to recover the amount of the loan out of the sale proceeds of the mortgaged property.
7. The interest in the mortgaged property is re-conveyed to the mortgagee on the repayment of the amount of the loan along with interest thereon.

Rights of a mortgagee

The rights of a mortgagee as specified in the Transfer of Property Act, 1882, are as follows:

1. Right to foreclosure or sale- The mortgagee has a right to obtain from the Court a decree that the mortgagor shall be absolutely debarred of his right to redeem the property or a decree that the property be sold. The former is called a suit for foreclosure. This right can be exercised by the mortgagee at any time after the mortgagee money has become due to him and before a decree has been made for the redemption of the mortgaged property and in the absence of a contract to the contrary. The right of foreclosure may be exercised by (i) a mortgagee by conditional sale, or (ii) a mortgagee under an anomalous mortgage, which authorises the mortgagee to exercise such right. A usufructuary mortgagee or a mortgagee by conditional sale is not authorised to file a suit for sale.

The right of the mortgagee is absolute and cannot be postponed in preference to other debts of the principal debtor. In *State Bank of India vs. Regional Provident Funds Commissioner* (A.I.R. 1965, M.P. 40), the Madhya Pradesh High Court held that the property mortgaged to the Bank would be sold only subject to the mortgage in favour of the Bank, even if the mortgagor was in default of the payment of employer's contribution to the Employees Provident Funds. The demand for the latter would not have any priority over other secured or unsecured debts of the employers. The Court held that the Employees Provident Funds Act, 1952 merely provides the manner of recovery of the employers' contributions, i.e., to recover the same in the same manner as arrears of land revenue. It does not have the effect of converting the arrears into arrears of land revenue, nor did it create any charge over any property of the employer or give a priority in the matter of payment of the amount.

2. Right to sue for mortgage money- Under Section 68, the mortgagee has a right to sue for the mortgage money in the following cases:

- (i) where the mortgagor binds himself to pay the money, or
- (ii) where the mortgaged property is wholly or partially destroyed or the security is rendered insufficient and mortgagor has failed to provide further security to render the whole security sufficient, or
- (iii) where the mortgagee is deprived of the whole or a part of his security by or in consequence of the wrongful act or default of the mortgagor, or
- (iv) where the mortgagee being entitled to possession of the mortgaged property, the mortgagor fails to deliver the same to him.

3. Right of sale without the intervention of the Court- Under Section 69, the mortgagee has the power to sell the mortgaged property or a part thereof without the intervention of the Court in the following cases:

- (i) where the mortgage is an English mortgage; and
- (ii) where the power of sale without the intervention of the Court is expressly conferred on the mortgagee by the mortgage deed and that mortgagee is the government or the mortgaged property or any part thereof was, on the date of the execution of the mortgage deed, situated within the towns of Calcutta, Madras, Bombay or in any other town or area which the State Government may specify in this behalf.

4. Right to the accession to mortgaged property- Section 70 enables the mortgagee to hold, for the purpose of security, any accession to the mortgaged property, which occurs after the date of the mortgage, if a contract to the contrary does not exist.

5. Right to sue and Right to realise the security are distinct rights- A mortgagee possesses the right to sue the mortgagor and also to sue for the realisation of his security. In Bihar State Electricity Board

and Another vs. Gaya Cotton & Jute Mills Ltd. (A.I.R. 1976, Patna 372) the High Court considered the question whether the mortgagee was bound to sue for the realisation of his security in a suit to enforce the personal covenants given by the mortgagor to pay the mortgage debt.

6. Right in case of renewal of mortgaged lease- When the mortgaged property is a lease and the mortgagor obtains renewal of the lease, the mortgagee, in the absence of a contract to the contrary, shall, for the purposes of the security, be entitled to the new lease (Section 71).

7. Right to recover money spent on mortgaged property- Under Section 72 a mortgagee may spend such money as is necessary for the following purposes and may add such money to the principal money, in the absence of a contract to the contrary. Interest on such money shall be payable by the mortgagor at the rate payable on the principal and, if no such rate is fixed, at the rate of 9% per annum:

- (i) for the preservation of the mortgaged property from destruction, forfeiture or sale;
 - (ii) for supporting the mortgagor's title to the property;
 - (iii) or making his own title thereto good against the mortgagor;
- and

4.3 SUMMARY

A sound banking is based on safety of funds lent by a banker to his customer. The first and the most important criterion to judge safety of funds is the capacity of the borrower himself to repay the amount of loan. Secured advances provide absolute safety to the banker by means of a charge created on the tangible assets of the borrower in favour of the banker. The modes of creating charge include lien, pledge, hypothecation and mortgage.

The right of general lien empowers the banker to retain all securities of the customer in respect of the general balance due from him. The banker is, however, not entitled to realise his from the said assets of the customer. Under pledge, the banker as a pledgee has the right to retain the goods pledged for the payment of the debt or the performance of the promise. The pledgee can also claim any extraordinary expenses incurred by him for the preservation of the security. The pledgee has the duty to return the goods on payment of debt and is also responsible to the pledger for any loss of goods, if the goods are not returned by him at the proper time.

Hypothecation, which is another method of creating a charge over the moveable assets, neither transfer ownership nor possession of good to the creditor but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so. Another mode of creating charge is mortgage. The right of a banker as mortgagee is to obtain from the court a decree that the mortgager (borrower) shall be absolutely debarred of his right to redeem the property or a decree that the property be sold.

4.4 KEYWORDS

CRR: The cash which banks have to maintain with the RBI as a certain percentage of their demand and time liabilities.

Bailment: Section 148 defines bailment as the “delivery of goods from one person to another for some purpose upon the contract that the goods be returned back when the purpose is accomplished or otherwise disposed of according to the instructions of the bailor”.

Pledge: According to section 172 of the Indian Contract Act, 1872 pledge is defined as “bailment of goods as security for payment of a debt or performance of a promise”.

Hypothecation: Hypothecation is another method of creating a charge over the movable assets. Under hypothecation neither ownership nor possession of goods is transferred to the creditor but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so.

Mortgage: Section 58 of the Transfer of Property Act 1882 defines mortgage as “the transfer of an interest in specific immovable property for the purpose of securing the payment of money, advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”.

4.5 SELF ASSESSMENT QUESTIONS

1. What is meant by the statement “Banker’s lien is tantamount to an implied pledge? Bring out the distinction between a lien, a hypothecation, a pledge and a mortgage. What is the difference between an Equitable Mortgage and a Legal Mortgage?
2. Discuss the characteristics of a mortgage, a pledge and a lien. As a banker which of these would you prefer as security and in what circumstances?
3. (a) Define a fixed charge and a floating charge.

- (b) A charge is created by a public limited company on its stock-in-trade in favour of your bank to secure a cash credit limit. What would be the effect of failure to register the charge under Section 125 of the Companies Act?
4. Define 'Pledge'. What are its essential ingredients? Who can create a valid pledge? What are the rights and obligations, respectively, of the pledger and the pledgee?

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Lesson: **5**

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Securities for bank advances

STRUCTURE

- 5.0 Objectives
- 5.1 Introduction
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- 5.2 Advances against goods
- 5.3 Advances against documents of title to goods
- 5.4 Advances against stock exchange securities
- 5.5 Advances against life insurance policies
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5.0 OBJECTIVES

After reading this lesson, you would be able-

- to understand the basic principles a banker should observe while granting advances against securities, and

- to know the nature of various types of securities offered to the banker.

5.1 INTRODUCTION

Lending is the main function of banking and banks can fail if their loans are bad. Moreover, banks can lose profits if they do not seize opportunities for good lending. Security protects the lender in case things go wrong. The assets commonly charged as security are mainly land (including buildings), stocks and shares, and life assurance policies. In law these are all 'choses in action', assets evidenced by documents (certificates, deeds etc.). Banks much prefer dealing with securities where ownership can be evidenced in this way rather than with chattels such as cars, plants and machinery or furniture. However, valuable this may be, it cannot be charged or controlled as effectively as land, shares or life policies. This lesson would cover general principles of secured advances, classification of advances against goods, advances against documents of title to the goods and advances against stock exchange securities.

5.1 GENERAL PRINCIPLES OF SECURED ADVANCES

While granting advances on the basis of securities offered by customers, a banker should observe the following basic principles:

1. *Adequacy of margin*- The word 'margin' has special meaning and significance in the banking business. In banking terminology, 'margin' means the difference between the market value of the security and the amount of the advance granted against it. For example, if a banker sanctions an advance of Rs. 80 against the security of goods worth Rs. 100, the difference between the two (Rs. 100 – Rs. 80 = Rs. 20) is called margin. A banker always keeps an adequate margin because of the following reasons:

- (i) The market value of the securities is liable to fluctuations in future with the result that the banker's secured loans may turn into partly secured ones.
- (ii) The liability of the borrower towards the banker increases gradually as interest accrues and other charges become payable by him. For example, if a loan of Rs. 100 is sanctioned by a banker today, the liability of the borrower at a future date, say, a year after, would be increased by the amount of interest accrued and other charges payable by him. Hence a banker keeps adequate margin to cover not only the present debt but also the additions to the debt.

2. *Marketability of securities-* Advances are usually granted for short periods by the commercial banks because their deposit resources (except term deposits) are either repayable on demand or at short notice. If the customer defaults in making payment, the banker has to liquidate the security. It is, therefore, essential that the security offered by a borrower may be disposed of without loss of time and money. A banker should be very cautious in accepting assets which are not easily marketable.

3. *Documentation-* Documentation means that necessary documents, e.g., agreement of pledge or mortgage, etc., are prepared and signed by the borrower at the time of securing a loan from the bank. Though it is not necessary under the law to have such agreements in writing and mere deposit of goods or securities will be sufficient to constitute a charge over them, but it is highly desirable to get the documents signed by the borrower. These documents contain all the terms and conditions on which a loan is sanctioned by the banker and hence misunderstanding or dispute later on may easily be avoided.

4. *Realisation of the advance*- If the borrower defaults in making payment on the specified date, the banker may realise his debt from the sale proceeds of the securities pledged to him. As discussed in the previous lesson, a pledgee may sell the securities. In case of loans repayable on demand a reasonable period is to be permitted by the banker for such repayment. This period may be a shorter one if there is urgency of selling the commodities immediately in view of the falling trend in their prices. If a banker is unable to recover his full dues from the security he shall file a suit for its recovery within the period of three years from the date of the sanction of the advance. In case of term loans repayable after a fixed period, the period of limitation (i.e., 3 years) shall be counted from the expiry of that fixed period.

5.2 ADVANCES AGAINST GOODS

The Scheduled banks in India sanctions advances against the security of the following types of goods and commodities broadly divided into four main heads as follows:

- (i) Food articles,
- (ii) Industrial raw materials,
- (iii) Plantation products, and
- (iv) Manufacturers and materials.

The advances against goods meet the needs of working capital of a large number of business and industrial concerns. In fact, such advances are essential for all trading and commercial activities in the country, i.e., for storing the agricultural output, the industrial raw materials and the finished products from the time of their harvest or production till their final consumption. The goods and commodities as security to the banker reveals the following merits and demerits:

1. Better security- Goods and commodities are tangible assets and provide better security to the banker as compared to the unsecured advances, including guaranteed advances and discounting of bills. If the debtor fails to repay the loan, the banker realises his dues by selling the pledged goods and may recover the balance, if any, from other property of the debtor. Even as a secured creditor the banker is not fully safe from the risk of fraud or dishonesty on the part of the borrower. With utmost precautions on his part, he cannot verify the quantity and quality of the goods pledged to him. It is practically impossible for the bank manager or the godown keeper to check and vouch the correctness of the contents of each and every bag, container or package stored in a godown. A dishonest borrower can deceive the banker by pledging goods which do not tally with the description given by him in the documents.

The goods are subject to the additional risk of deterioration in the quality of the goods. All goods are not equally durable. Foodgrains and agricultural crops are likely to be damaged, reduced in weight or may become worthless if stored for a very long period of time. Goods and commodities are, therefore, suitable securities for advances for a shorter period only.

2. *Prices of necessary goods are stable-* The prices of the goods which are necessities of life are relatively stable over a short period, though not necessarily over a long period. But wide variations in the prices of luxury goods take place due to changes in demand, fashions and tastes of the people. Bankers are generally reluctant to accept the commodities the prices of which are uncertain and fluctuate too widely and frequently. The problem of valuation of stocks pledged is not a difficult one, as daily market quotations are published in the papers and more quotations can be had from reliable traders and brokers.

3. *Goods and commodities can be liquidated more easily.* Some commodities like wheat, sugar and cotton enjoy ready market while the demand for manufactured articles of seasonal utility or of durable consumer goods is not constant throughout the year. The banker is naturally inclined to accept the commodities having regular and steady demand and wide market.

4. *Bankers Lend Shorter duration of advances against goods-* Because the goods and commodities decay or deteriorate in quality over a period of time, bankers lend against them for shorter periods only. In practice, however, the advances continue even after the normal period is over and are renewed for another period. Such loans are called 'rolled over loans'. Advances against documents of title to goods like the bill of lading or railway receipt are self-liquidating in nature because as soon as the documents are handed over to the consignee against payment or acceptance of the bill of exchange the banker gets back the funds lent by him.

Precautions to be taken by a banker: A banker should be very careful in accepting goods and commodities as security and take the following precautions:

1. While the goods and commodities are the best securities to a banker for granting loans, the customer is also equally important. The customer must be honest and trustworthy otherwise the risks of fraud or dishonest practices always remain. The banker should depend upon his past experience about the customer and also on the goodwill enjoyed by him in the market. The customer must know his trade well and should possess adequate practical experience therein.

2. The banker must be well acquainted with the nature of demand of the commodity being accepted as security. He must enquire

whether the commodity is an item of necessity, comfort or luxury and whether its demand is elastic or otherwise, is constant throughout the year or is seasonal in nature. He should readily accept the commodities which are necessities of life and are regularly consumed by a large number of people because of their easy marketability in case of need.

There is also need to confirm whether the commodity can be stored for a reasonable period of time without deterioration in its quality or value. Some commodities like rice appreciate in value if stored for some time but other agricultural products are damaged if stored for a long period.

3. The banker should have full knowledge of the commodity market. He should know well the commodities offered as security, the conditions and customs of their trades and also the trend of their prices in the market. Such knowledge is essential for him to regulate the margins to be maintained.

4. The banker should estimate the value of the goods very carefully. He should ascertain the exact quantity of the goods pledged and find out their prices in the market through a broker, if necessary. The invoice price, given by the borrower, should be checked because it might be an inflated one.

5. The goods should be adequately insured against fire, theft, etc. as the fire insurance policies contain an 'Average Clause', the banker must get the goods insured for their full value irrespective of the amount of the loan advanced because if the full value is not insured the insurance company will pay the damages in the same proportion in which the total value stands to the amount insured.

6. It is very important for the banker to ensure that goods released should be in proportion to the amount of the loan repaid by the

customer. Hence the banker should strictly regulate the delivery of the goods. All deliveries must be sanctioned by the Manager through the Delivery Orders specifying the quantum of goods and their distinctive numbers. It is also essential that responsible officials should inspect the godowns frequently and without notice to ensure effective check.

7. The banker should take delivery of the goods before he grants a loan against it to a customer. Delivery may be either actual delivery or constructive delivery. In case of the latter, the customer hands over the keys of the godown storing the goods to the banker or transfers the services of the watchman. In some cases the banker provides facilities usually called “factory type”, meaning thereby that the stocks pledged with the banker are permitted to be processed or utilised by the debtor. The banker retains this charge over the same and a name-plate of the banker is displayed at an important place in the business premises of the debtor to indicate that the goods are pledged to the banker. Wherever desirable, a contract of hypothecation may also be entered into to provide such facilities to the borrower.

8. The banker should also take necessary care regarding the storage of the goods pledged. The godowns should be safe from water, fire, etc., and should be situated in a good locality. Proper record should be kept in the godown register. Serial number of the godown and its capacity and size should also be recorded.

5.3 ADVANCES AGAINST DOCUMENTS OF TITLE TO GOODS

A document of title to goods represents actual goods in the possession of somebody else. It confers on the purchaser the right to receive the goods and to transfer such right to any other person by mere delivery or by endorsement and delivery. A document of title to goods is a

document used in the ordinary course of business as a proof of the possession or control of goods. Bill of Lading, Dock Warrants, Warehouse-keeper's or wharfinger's certificate, railway receipts and delivery orders are the instances of the documents of title to goods. There are two tests by which we may judge the validity of such a document:

- (a) The person who possesses such document is recognised by law or by business practice as possessing the actual goods; and
- (b) The person who possesses such document can transfer the goods to any person by endorsement or delivery or by both. The transferee is thus entitled to take delivery of the goods in his own right.

Documents of title to goods must be distinguished from those documents which are mere acknowledgement of receipt of the goods. In case of documents of title to goods, the person possessing such documents is entitled to have the legal title to goods. If the person in whose possession the goods lie becomes insolvent, the official receiver will not include such goods amongst the total assets of the insolvent.

The advances against documents of title to goods are subject to the following risks:

1. Greater risks of frauds and dishonesty- The transporter or warehouseman grants a receipt for the goods entrusted to him but he does not certify or guarantee the correctness of the contents of the bags or the packages. A dishonest trader may deceive the banker by giving false description of the goods in the documents of title which are pledged with the banker. For example, if a trader despatches by rail hundred bags containing sand but gives the description of sugar on the forwarding note, he receives a railway receipt for sugar bags which may

be handed over to the banker for securing an advance. The banker will have no remedy against the transporter in such circumstances.

2. Not negotiable documents- The documents of title to goods are not negotiable instruments like cheques, bills of exchange or promissory notes. A negotiable instrument confers on its bonafide holder in due course an unimpeachable title to the goods irrespective of the defect in the title of the endorser or the transferor. The documents of title to goods are however, transferable ones and can be endorsed to any person but the transferee does not get a better title than of the transferor.

3. In case of railway receipt there is the risk of the borrower's taking delivery of the goods on the basis of an indemnity bond, while the railway receipt is given to the banker as security. An interesting case of such fraud was reported in which five wagons containing 415 bales of fully pressed cotton were delivered in a private siding belonging to a firm of Saharanpur and unloaded by them without producing the railway receipt, which was duly endorsed in favour of United Commercial Bank. The bales were pledged to the Central Bank of India and the firm took an advance from the latter. The Railway Protection Force alleged lapse on the part of the railwaymen for allowing self-booked goods to be placed into the private siding without surrendering the railway receipt by the party and negligence on the part of the bank authorities for not ascertaining the ownership of the bales before advancing huge sums. The RPF took into possession the bales from the godowns of the firm and the same were handed over to the Central Bank of India on superdari (entrustment) by the Court.

Precautions to be taken by the banker

1. The goods must be insured for its full value against the risks of fire, theft, etc.

2. To ensure that the goods packed in bags, etc. actually conform to the description contained in the documents, it is desirable that a certificate from a reliable firm of packers is obtained, especially in case of valuable goods.
3. The banker should also take a memorandum of charge from the borrower authorising the banker to sell the goods if the borrower defaults in making payment.
4. It is also essential that the issuer of the document of title to goods, i.e., transporter, warehouseman, etc., is a reliable person or firm.
5. In order to avoid risks of fraud and dishonesty, the banker should accept such documents as security from honest, reliable and trusted parties only.
6. Special care should be taken to see that documents are genuine and not forged ones.

Important documents of title to goods

1. **Bill of lading-** A bill of lading is a document issued by a shipping company acknowledging the receipt of goods for carrying to a specified port. It also contains the conditions for such transportation of goods and full description of the goods, i.e., their markings and contents as declared by the consignor. The shipping company gives an undertaking to deliver the goods to the consignee or to his order in the same condition in which it has received, on payment of the freight and other charges due thereon. It is to be noted that a Bill of Lading is prima facie evidence of the fact that the packages, as specified therein, were put on board the ship but the shipping company is not responsible for the contents of the bags or the bales entrusted to it for transportation. It is, therefore, essential for the banker to accept such documents from reliable and trustworthy parties only.

Bills of lading are issued in sets of three, duly signed and bearing the mark 'original', 'duplicate' or 'triplicate', respectively. The shipping company delivers the goods on presentation of any one of the three copies of the bills of lading, thus rendering the other two ineffective. It is, therefore, essential for the banker to demand all the three copies of the bill of lading duly endorsed, before an advance is made against it.

A bill of lading is not a negotiable instrument, though it is transferable by endorsement and delivery. Therefore, a bonafide holder for value of such a bill of lading does not get title to the goods better than that of the transferor of the documents. He can sue in his own name and can give valid discharge.

2. Warehouse receipts- An important objective of promoting warehousing in the country has been to enable the owners of commodities-agriculturists and traders-to acquire a convenient security in the form of warehouse receipt, which can be accepted as security by the banks. To popularise the warehouse receipts as security for loans from banks, the Reserve Bank granted some concessions in respect of such advances in its selective credit control directives in the past. Most of the advances against warehouse.

3. Railway receipt- Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is transferable but not a negotiable instrument. It can be transferred by endorsement and delivery. As the receipt is to be produced before the railway authorities to clear the goods at the destination, advances sought against such receipt are for very short periods. Generally, the consignor of the goods draws a bill of exchange or a hundi on the consignee for the amount of the goods consigned and discounts the bill/hundi with the banker. The railway receipt is enclosed with the bill which is called a documentary bill. The

banker releases the railway receipt to the consignee against payment/acceptance of the bill. The Bombay High Court held that an endorsee of a railway receipt could not file a suit for damages for short delivery in consignment of the goods unless he had been shown to be the owner of the goods. Though this right of action is ordinarily vested in the consignor but the consignee, who is in possession of a railway receipt duly endorsed by the consignor, may maintain an action, but he could do so not because he is the consignee, but because he is the owner of the goods. A bare consignee who is not the owner of the goods could not maintain a suit for such compensation. The banker should take the precautions that the consignor may give wrong description of the goods consigned. The banker should, therefore, discount only such documentary bills with railway receipt which are drawn by parties of repute.

Sometimes the goods are delivered by the railway authorities on the basis of indemnity bond furnished by a wrong party. In such circumstances, the banker shall have to file a suit in the court of law. To avoid such a situation, the banker should inform the railway authorities at the destination about his interest in the goods and ask them not to release the goods without the railway receipt duly discharged.

4. Trust receipts- The goods or the documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes the borrower wishes to get the security released before he actually repays the loan. In such cases, the banker may, at his discretion, allow the customer to get back the goods or documents and ask the latter to execute a Trust Receipt. By signing such receipt, the customer undertakes to receive the goods or the documents of title to goods in trust for the lender. The borrower promises to hold the goods or their

sale proceeds as trustee for the banker and to pay the same to the latter as and when received.

5.4 ADVANCES AGAINST STOCK EXCHANGE SECURITIES

The term stock exchange securities refer to those securities which are dealt with on the stock exchange. These securities possess the following merits-

1. Security- Though the stock exchange securities are paper documents, they are treated as tangible assets because of their easy marketability. Government and semi-Government securities are rated high because of utmost confidence of the people in the Government and institutions sponsored by the Government. The prices of good securities do not fluctuate widely in normal times.

2. Liquidity- The stock exchanges provide a ready market for these securities. They can be disposed of more quickly and conveniently as compared to any other security. Government and semi-government securities are called 'Gilt-edged securities' because of their steady market and stable prices. Moreover, the banker can repledge these securities with the Reserve Bank of India or any other banker to secure accommodation, if need arises.

3. Accrual of income- The securities yield income by way of interest and dividend. The income received by the banker on such securities is adjusted towards the dues to be recovered from the customer and to that extent the latter's liability towards the banker is reduced.

4. Convenience- It is convenient for the banker to accept stock exchange securities because he can easily examine the title of the holder.

Moreover, their market prices can be easily ascertained by referring to the reliable quotations published in the papers/periodicals, etc.

Government securities

Government securities are the safest and easily realisable securities for bank advances. Government securities may be issued as (i) inscribed stock, or (ii) promissory notes. Government promissory notes contain a promise on behalf of the President of India, in case of Central Government Securities, or the Governor of the State concerned, in case of State Government Securities, to pay the specified sum of money to the holder of the Note (i.e., either the payee or the last endorsee whose name appears on the back) on a specified date or after a certain notice, subject to the terms and conditions of issue. The Promissory Note also contains the rate at which interest is payable half-yearly. Government Promissory Notes are negotiable instruments. Title thereto can be transferred by endorsement and delivery. While pledging the securities to the banker, the borrower should endorse them in favour of the banker and also execute a letter of pledge. It is not difficult to ascertain the borrower's title to the securities.

National saving certificates

The Central Bank has permitted the banks in India to grant advances against National Saving Certificates. Banks are directed to prescribe a margin of 25% on the original investment in these certificates, without taking into account accrued interest. Thus, advance may be granted to the extent of 75% of the value of such certificates.

For this purpose an application is to be made in the prescribed form by the transferor and the transferee to the Post-Master of the office of registration, who will permit the transfer of the Certificate to, amongst others, a scheduled bank or a co-operative bank. If the certificates have

been purchased on behalf of a minor, the parent/guardian should certify in writing that the minor is alive and the transfer is for the benefit of the minor. The Post Master shall make the following endorsement on the Certificate: “Transferred as security to ...”

Kisan Vikas Patras

The Reserve Bank of India has permitted the Commercial banks to grant loans against the security of ‘Kisan Vikas Patras’. Banks should take account the purpose of the loan and should follow the Reserve Bank’s direction on interest rates. The Patras can be treated as main security. Margin is to be determined on the basis of the residual period for which the certificate is to run and other relevant factors.

The maturity period of such Patras is five and half years. A certificate can be prematurely encashed (i) on the death of the holder or any of the holders in case of joint holders, (ii) on forfeiture by a pledgee, being a gazetted Government officer or (iii) when ordered by a court of law.

Indira Vikas Patras

Advances against these patras can be granted after considering the purpose. Premature encashment of these patras is not allowed. Hence margin may be determined by the banks depending upon the residual period for which the certificate is to run.

The patras can be pledged in favour of the banks. No lien can be registered as the certificates are issued without registering the name of the purchaser. Banks should take utmost care for their safe custody, as they are freely transferable.

Corporate securities

Securities issued by joint stock companies fall into following categories:

Preference shares- Preference shares of a company are those shares which carry certain preferential rights for their holders over those of the equity shareholders. Preference shares carry a prescribed rate of dividend, which the company shall have to pay before any dividend can be distributed to the equity shareholders. Preference shares may be either (i) cumulative preference shares or (ii) Non-cumulative preference shares. In case of the former, if the company is unable to pay the prescribed dividend during any year/years, the same is payable out of the profits of the company in future years. The holders of non-cumulative preference shares do not enjoy this right. Again, the preference shares may be redeemable or non-redeemable. The former are repaid after the period specified therein.

Debentures- Debentures are generally secured by way of mortgage of immovable property of the company. The owners of such secured debentures are the secured creditors of the company. Unsecured debenture-holders do not possess any such charge over the assets of the company. These debentures are usually redeemable ones; their redemption takes place after a stipulated period of time. Companies are now issuing debentures of 7 or 8 years' maturity. As regards the payment of interest, companies are nowadays issuing debentures under the following two scheme, viz.-

Scheme A- Non-cumulative interest scheme. Under this scheme interest is payable half-yearly.

Scheme B- Cumulative interest scheme. Under this scheme interest from the date of allotment will be accumulated with half-yearly rests on the principal amount and the accumulated interest thereon, till

the debentures are redeemed. Such accumulated interest becomes due and payable on redemption.

Risks in advances against shares

1. Liability in case of partly paid up shares- If the shares pledged by the borrower are partly paid-up, the company may make calls thereon. The banker or his nominee, if registered as the owner of these shares in the company's books, will be liable to make payment of such calls. Therefore, he should be very careful in accepting the partly paid-up shares. Banks are now directed by the Reserve Bank not to accept partly-paid shares as security without securing its prior approval.

2. Company's right of lien on shares- Generally, the Articles of Association of a company provide that the company will have a right of lien on its shares, if a shareholder fails to make payment of calls made by the company or of any other dues payable by him. The banker should, therefore, inform the company about his charge over the shares to safeguard his position.

3. Not negotiable securities- In case of not negotiable securities, the banker cannot get title better than that of the transferor of such securities.

4. Risk of forgery- Sometimes share certificates are issued by companies in duplicate or triplicate on receipt of request from their shareholders. Banker should, therefore, ensure the genuineness of the share scripts.

Precautions to be taken by the banker

1. **Selection of shares-** The suitability of shares as security for bank loan depends upon their price stability and easy marketability, which in turn depend upon the success of the enterprise which they

represent. Bankers, therefore, accept only those shares which they approve after thorough screening and examination of all aspects of a unit's working. Generally, they prepare a list of the approved securities after they are satisfied as regards the following:

(a) The nature of business of the company and the position of the company in the particular industry in the past; and the future prospects of the business of the company. If all these are quite favourable, the security is rated high.

(b) The competence of management as the success of an enterprise depends upon the competence of its management-technical, financial and managerial.

(c) The banker forms his opinion about an enterprise on the basis of its financial results for the last few years. A study of the balance sheet and profit and loss account of the last few years enable the banker to anticipate its profitability in future years. The study of the balance sheet also reveals the position of the liquid assets in relation to current liabilities and that of reserves in relation to capital.

(d) The study of movements in the share prices over a reasonable period is also essential. If the prices show a steady and regular tendency to rise, without frequent and sharp fluctuations, such security is rated high and preferred by the banker as security for an advance.

2. Valuation of securities- Following precautions should be taken by the banker in this regard:

(a) The prices quoted in daily newspapers and financial periodicals should be consulted. In case of shares which are transacted

very rarely, the banker should ask the secretary of the company to quote the price at which the last transaction took place.

(b) Generally, the share prices are quoted cum-dividend, i.e., the buyer of security remains entitled to the current year/half-year's dividend. Therefore, the amount of such dividend should be deducted from the current market prices.

3. Creation of charge over securities- A charge over the securities may be created in either of the two ways:

(i) Legal title- Most of the securities transacted on the stock exchanges are registered stocks and shares. Their transfer must be registered in the books of the issuing companies. Thereafter the transferee acquires legal title to the securities.

The legal title to the securities is transferred to the banker when either the banker or his nominee is registered as a shareholder in the books of the company. From the banker's point of view transfer of legal title is very desirable but the borrower shows his reluctance to do so because-

(a) The registration of transfer and re-transfer of the shares entails expenses which are payable by the borrower himself.

(b) The fact of such registration is made known to the people. The reputation of the borrower is likely to be adversely affected.

(c) By transferring the shares to the banker the borrower lose his directorship as well because the number of shares held by him might fall below the minimum qualification shares required to remain a director.

(ii) Equitable title- As an alternative to the transfer of legal title, equitable title may be transferred in favour of the banker by depositing the security with the latter without the registration of its transfer. The borrower deposits the securities with the banker and agrees, either expressly or impliedly, that the securities have been deposited with the aim to secure a debt taken from the bank. The transfer of securities to the banker is not registered in the books of the company, equitable title is given to the banker in either of the two ways-

(a) By memorandum of deposit- The banker takes a memorandum of deposit from a reliable borrower, specifying the purpose of such deposit so that no dispute may arise in future. It also authorises the banker to sell the securities if the customer defaults in making payment or in maintaining the required margin. The memorandum also authorises the banker to debit the customer's account with the amount he pays on partly-paid shares deposited by him.

(b) By bank transfer- When the customer deposits the securities together with the transfer forms signed by the transferor without specifying the name of the transferee and without mentioning the date, equitable title is created in favour of the banker. This is called blank transfer. The banker gets the shares transferred in his name or in the names of his nominees whenever he feels it necessary. Otherwise, the blank transfer form remains unutilised with him. When the shares are duly registered in the name of the banker or his nominee, the latter gets legal title to them.

Reserve bank's guidelines regarding advances against shares

While granting advances against shares, banks are required to follow the guidelines issued by the Reserve Bank of India in this regard. The main points contained in these guidelines are as follows:

1. Banks should strictly observe the statutory provisions in this regard contained in sections 19(2) and (3) and 20(1) (a) of the Banking Regulation Act, 1949.

2. Banks should exercise due caution and restraint in lending against shares and debentures. They should take into account the nature, purpose and need for such advances to ensure that finance is not utilised for speculative purposes.

3. Advance against the primary security of shares and debentures should be kept separate from other advances and should not be combined with them.

4. Banks should be satisfied about the marketability of the shares/debentures. Net worth and working of the company issuing the shares/debentures should also be investigated.

5. Shares and debentures should be valued at the current market price.

6. Banks should maintain adequate and proper margin while granting advances.

7. Advances should not be granted against the security of partly paid up shares.

8. Where advances are sought against large blocks of shares by a borrower or a group of borrowers, bankers should exercise particular care. They should ensure:

- (i) The borrower's ability to repay the advance, and also
- (ii) that the advance is not utilised for purposes other than short-term productive purpose.

- (iii) that the advance is not used to enable the borrower to acquire or retain a controlling interest in the company or to facilitate or retain inter-corporate investments.

9. It should also be ensured that a single borrower or a group of borrowers do not obtain large credit against shares/debentures from different banks. It should also be ensured that such accommodation from different banks is not obtained against shares of a single company or a group of companies.

10. Where the limits of advances granted to a borrower against shares/debentures exceed Rs. 10 lakh, the shares/debentures should be transferred in the bank's name. The bank should have the exclusive and unconditional voting rights in respect of such shares. For this purpose, advances against shares/debentures granted by all the offices of a bank to a single borrower are taken into account.

11. In respect of those scrips which are held by the bank as security against advances granted to share and stock brokers (registered with securities and exchange board of India and members of recognised stock exchange), the period for getting the shares and debentures transferred in the bank's name shall be nine months. Banks should obtain duly executed blank transfer forms for shares pledged by the share and stock brokers. The share brokers can freely substitute the shares pledged by them as and when necessary. In case of default banks should exercise the option to get shares transferred in their name.

Banks shall exercise the voting rights on the above-mentioned shares only with the prior approval of the Reserve Bank and in accordance with the direction given by it.

12. Advances above Rs. 5 lakhs against shares and debentures should be sanctioned by the Board/Committee of Directors.

13. Advances against the primary security of shares/debentures may be given to-

- (i) individuals
- (ii) investment companies
- (iii) stock and share brokers, and
- (iv) trusts and endowments

14. Loans may be granted against shares and debentures to individuals for the following purposes:

- (i) for meeting contingencies and needs of personal nature, or
- (ii) for subscribing to rights or new issues of shares and debentures, and
- (iii) for the purchase of shares and debentures in the secondary market.

Appropriate repayment schedules should be chalked out.

The maximum amount of such loans granted to individuals was initially fixed at Rs. 5 lakh, which was raised to Rs. 10 lakh in September 1996. a minimum margin of 50% was also stipulated for such advances. In October, 1997 Banks were given the freedom to stipulate margins on loans to individuals against preference shares and debentures/bonds of corporate bodies.

The above ceiling has been raised to Rs. 20 lakh on April 29, 1998, if the advances are secured by dematerialised securities. The minimum margin against such dematerialised shares has also been reduced to 25 per cent.

In April 1988 banks were permitted to provide finance to the employees of the companies to acquire shares issued by their companies. Advances upto 90% of the purchase price of the shares not exceeding Rs.

50,000 or 6 months salary, whichever is less, can be sanctioned by banks. The loan is to be recovered in monthly instalments within 3 years.

15. In case of investment companies, banks may grant advances of a bridging nature for a period up to 9 months to cover the gap between their current resources and their existing and proposed investment in shares/debentures. The total outside liabilities on an investment company (including the proposed bank borrowing) should not exceed 10 times its own funds. The company's operations should not be confined to a company or a group of companies.

16. Reasonable overdraft facilities against shares and debentures may be given to share and stock brokers, after making a careful assessment of their requirements for such finance. Bank should not encourage large-scale investment in shares and debentures on own account by stock and share brokers with bank finance. There must be regular turnover in the shares/debentures lodged as security.

17. In case of trusts and endowments, banks can grant bridge loans up to 9 months for the purpose of fresh investments/subscriptions to rights issues. Maximum amount of Rs. 5 lakhs may be granted to each borrower.

18. In case of companies or industrial borrowers banks can grant advances to meet margin requirements for short periods up to 1 year against the collateral security of shares and debentures.

In April 1997, Reserve Bank of India permitted the banks to extend loans to corporate against shares held by them to enable them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources.

Such loans, according to Reserve Bank's direction, will be treated as banks' investment directly in shares and would come within the ceiling of 5%. This step has been taken to revive the primary capital issue market. The period of repayment of such loans and the margin will be determined by banks themselves.

5.5 ADVANCES AGAINST LIFE INSURANCE POLICIES

In India, the Life Insurance Corporation of India and several private companies are engaged in the business of life insurance. They have issued several kinds of life insurance policies, to suit the needs of different classes of people, e.g., endowment policies, multipurpose policies, fixed-term marriage endowment policies, educational policies, etc. The primary objective of the insured in a large number of cases happens to make a provision for his old age or to secure protection to his dependants in case of his untimely death.

Merits of insurance policies as security

A Life Insurance Policy is deemed a suitable security by a banker because of the following merits:

1. The policy can legally be assigned to the banker- According to the terms and privileges of the Life Insurance Policy, it can be assigned to anybody including a banker and such assignment is duly registered by the life insurance companies. By such assignment of the policy, the banker becomes entitled to receive the sum assured on the date of maturity or the death of the borrower.

2. As the Life Insurance policy is handed over to the banker after its assignment is registered in the books of the L.I.C. the banker need not worry about the supervision of the security.

3. It is an easily realisable asset. Its value can be easily realised by the banker on the death of the customer. The formalities required to be undertaken by the banker are few and not difficult.

Drawbacks of Life Insurance Policies

1. Life insurance is a contract of utmost good faith. The insured is, therefore, required to disclose to the insurer all material facts relating to the life assured which are within his knowledge and which might affect the decision of the insurer to accept the proposal or not.

2. Under a contract of insurance, the insured promises to pay premia to the insurer at regular intervals failing which the policy lapses. The surrender value is payable only when the policy is continued for a certain minimum period. The banker thus bears the risk arising out of the non-payment of premia by the insured. Sometimes, he himself pays the premium in order to keep the policy alive and to secure its surrender value.

3. Life policies sometimes contain some special conditions also. For example, a “suicide clause” may be incorporated therein to the effect that the policy shall become invalid if the assured commits suicide within a given initial period. Similarly, the policy may contain a restrictive clause also, prohibiting the insured from engaging himself in hazardous activity or occupation.

If a duplicate copy of the policy has been issued by the insurer, care should be taken by the banker. He should also ascertain that the policy is without any previous encumbrance.

Precautions to be taken by the banker

1. Existence of insurable interest- A life insurance policy may be taken by a person on his own life or on the life of any other person.

But according to the law of insurance, it is essential that the insured must have insurable interest in the life assured at the time of proposal; not necessarily at the time of maturity of the policy. Insurable interest means pecuniary or monetary interest in the life assured, i.e., the person securing the insurance policy will suffer monetary loss or hardships if the life assured expires. Insurable interest exists in one's own life, in the life of wife/husband, son/parents who support such person. Third parties may also have insurable interest, e.g., the creditor may have insurable interest in the life of the debtor or that of the surety so that the former may be able to realise his claim from the debtor if he dies. Partners in a firm have such interest in the life of each other partner. The banker must ascertain whether insurable interest existed at the time the policy was issued.

2. Proof of age admitted by the insurance companies- The Life Insurance company requires proof of age of the life assured because the amount of premium depends upon the age of the assured. The banker should see that the age has been admitted by the L.I.C. on the basis of either the certificate of birth or the horoscope and the same has been properly recorded on the policy itself or by a separate letter. If it has not been done the banker must insist upon the customer to take steps in this regard, before a loan is sanctioned to him.

3. Preference for endowment policies- The banker should prefer endowment policies as compared to the whole-life policies because the former mature at a certain date or on the death of the assured, whichever is earlier. Whole life policy always matures on the death of the assured. Some banks accept only the 'endowment policies' (with or without profit) as security against advances.

4. Ascertain the surrender value- The banker should ascertain the surrender value of the policy from the insurance company before

granting an advance. He should also keep a margin on such surrender value. Generally, a margin of 5 or 10 per cent of the surrender value of the policy is maintained.

5.6 ADVANCES AGAINST REAL ESTATE

Though real estates, i.e., immovable property like land and buildings, are tangible assets, commercial banks do not regard them suitable security for advancing loans. Banker's reluctance to accept real estate as security is largely due to the following practical difficulties and legal complications-

(i) Ascertaining the title of the owner- Before accepting the real estate as security, the banker must ascertain the title of the owner to the property to be mortgaged. This is a difficult task because the laws are quite complicated. The banker, therefore, asks his solicitors to examine the documents of title to property to ascertain whether the borrower possesses the right to mortgage the property. It is also to be confirmed that the property is unencumbered, i.e. no prior charge exists, otherwise the second charge over the property in favour of the banker will have second priority. This is done by inspecting the Register of Mortgages for which necessary expenses are to be incurred and much time is spent.

The problem of establishing the right of ownership is extremely difficult in case of agricultural land because land records are not properly maintained. Even if the initial survey and settlement of land have taken place, subsequent changes, if any, in ownership as a result of sale or partition of land often fail to get promptly and correctly recorded in the basic village records. Land records relating to cultivating tenants are still less satisfactory, as the provisions of land reform legislation are widely circumvented and oral or informal tendency is widespread. In the

absence of up-to-date and accurate record of rights in land, it is difficult for the banker to accept such land as security.

(ii) Restrictive laws- The commercial banks are placed at par with other ordinary money-lenders under the debt relief laws and other Acts regulating money-lending with the effect that they are also restricted from proceeding against defaulters, who are agriculturists. In some cases, the agriculturists are barred from transferring their land to the commercial banks. These restrictive laws limit the utility of land as a suitable security for the commercial banks. The Rural Credit Review Committee, therefore, recommended that those features of the legislation which inhibit the commercial banks from providing credit to agriculturists be deleted by the State Governments.

(iii) Land and buildings are not readily realisable assets- These are, therefore, not preferred by the commercial banks because of their obligation towards the depositors to repay their deposits on demand. Arranging the sale of land and buildings takes time as their demand is influenced by many factors. Sometimes, it is difficult to dispose them of quickly. In the absence of a ready market, real estates are not considered easily marketable assets and the funds of the banker remain unrealised for a considerable period of time, if the borrower defaults.

(iv) The valuation of property is a difficult problem- If the banker accepts a building as security for a loan, he is naturally interested in the realisable value of the property and not its book value or its cost of construction. The total amount invested in a building by the customer might not be realisable if the property is offered for sale because of its location, special type of construction or lack of demand at a particular time. Expert valuers or brokers are, therefore, deputed by the banker for valuing the property offered as security.

(v) Legal formalities- Preparation of mortgage deed and its registration takes time and expenses are incurred in the form of stamp duty, registration fee, etc. Thus much cost is involved in creating a charge on real estates in favour of the banker.

Precautions to be taken by the banker

Financial soundness of the borrower- A prudent banker always scrutinises the financial soundness of the borrower and the viability of his business enterprise for which a loan is to be advanced. He should be satisfied about the capacity and competence of the borrower to return the borrowed money from his own resources. Though he is legally entitled to take recourse to the mortgaged property, a banker likes to avoid this and depends upon the financial soundness of the borrower.

Examination of the documents of title- the banker should refer the documents of title to property to his lawyer, to ascertain whether the mortgagor possesses absolute and undisputed title to the property and also the right to mortgage it. The banker and his lawyer should examine the Abstract of Title to find out the transfer of property in the past. Banker should entertain any such proposal, if the solicitor confirms borrower's absolute right in the property.

Investigation of prior charge over the property- it is also essential for the banker to ascertain whether the property, offered as security, is unencumbered and without having any previous charge in favour of any other party. The banker should, therefore, conduct search by a lawyer into the Register of Mortgages and charges either since the purchase of property by the mortgagor or for the last 20 years, whichever period is shorter.

Valuation of the property. Valuation of real estate must be undertaken by the banker very carefully. The banker usually entrusts

this work to the expert valuers or engineers who take into account all the relevant factors before computing the value of the property. The following factors should be taken into consideration in this regard:

Sufficient margin to be maintained- As an immovable property is not an easily realisable security and its estimated value is just a guesswork, bankers should safeguard their interest by keeping sufficient margin. Banks generally keep margin ranging between 33% and 50% of the value of the property.

The property must be insured- The banker should insist that the building to be mortgaged must be insured against fire to the extent of its full value irrespective of the amount of the loan advanced. It is essential to safeguard the banker's interest because the 'Average Clause', inserted in the fire insurance policies, makes the insurance

5.7 ADVANCES AGAINST FIXED DEPOSIT RECEIPTS

A fixed deposit made by a depositor with a banker is repayable after the specified period is over. If, in the meanwhile, he is in urgent need of money, he may take an advance from the banker on the security of the fixed deposit receipt or alternatively he may request the banker for the repayment of the deposit before its due date. While making advances against fixed deposit receipts, the banker should observe the following precautions:

A fixed deposit receipt issued by the same bank is the safest security for granting an advance, because the receipt represents a debt due from the banker himself. Recently the reserve bank has, therefore, advised the banks that advances against the security of their own deposits may be excluded from the purview of "exposure ceiling." A banker should not grant an advance on the security of a fixed deposit

receipt issued by another bank because the latter possesses its paramount lien over the receipt.

The banker should normally advance a loan to the same person or persons in whose name/names the receipt is issued. In case it is issued in the names of two or more persons, and loan is sought by one of them, all the depositors must sign a letter of authority authorising the bank to sanction a loan to one of them on the basis of the receipt.

While handing over the receipt to the banker as security, all the depositors must discharge it by signing across a revenue stamp and must also sign a memorandum of pledge. The banker is thereby authorised by the depositors to appropriate the amount of the fixed deposit receipt towards the repayment of the advance taken from the banker. Their signatures must tally with their specimen signatures.

According to the Reserve Bank directive a margin of not less than 25 per cent is to be maintained by banks while granting loans against any deposit. When an advance is granted against a fixed deposit or a deposit under Re-investment Scheme, accrued interest should be taken into account for determining the margin, i.e., the amount of loan to be sanctioned is to be ascertained on the basis of the principal amount and the interest accrued up-to-date.

After sanctioning a loan, the banker must make a note of the lien in his Fixed Deposit Register and also on the receipt itself. In case the receipt is issued by another branch of the same bank, the latter must make the same note and verify the signature of the depositor and the fact that no prior lien exists. The lending branch should advance the money only after the above has been done by the other branch which has issued the receipt.

If the receipt stands in the name of a minor, the banker should not grant a loan for reasons already discussed in Chapter 5.

5.8 ADVANCES AGAINST BOOK DEBTS

Sometimes a customer of a banker may seek an advance on the security of his book debts which have either become due or will accrue due in the near future. In other words, the debt which the customer has to realise from his debtors is assigned to the banker. Section 130 of the Transfer of Property Act, 1882, permits the assignment of an actionable claim to anyone except to a judge, a legal practitioner or an officer of a Court of Justice. According to Section 3, “actionable claim” means a claim to any debt or any beneficial interest in movable property not in the possession of the claimant which the civil courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent.

The banker should take the following precautions while advancing a loan on the security of a book debt:

The banker must enquire into solvency of the party owing debt to the customer and also the validity of the debt.

The assignment of book debt must be effected by the execution of an instrument in writing, signed by the transferor or his duly authorised agent, clearly expressing his intention to pass on his interest in the debt to the assignee. He may pass an order to his debtor to pay the assigned debt to the banker. If the debt is in the form of a promissory note, the assignment must be made on the note itself.

Notice of assignment must be served on the debtor by the banker. Though assignment is not rendered ineffective or invalid for want of such

notice, it is essential so as to make the debtor liable to make payment to the assignee.

The banker should also take an undertaking from his customer to pass on to him the amount received by the customer from his debtor in respect of the assigned debt.

After the assignment of the debt, all rights and remedies of the transferor, whether by way of damages or otherwise, shall vest in the transferee and the latter may use of institute proceedings for the same in his own name without obtaining the transferor's consent and without making him a party thereto.

The transferee of an actionable claim shall take it subject to all the liabilities and equities to which the transfer was subject in this respect at the date of the transfer (Section 132).

Example- A transfers to C a debt of Rs. 5,000 due to him by B. A was at the time indebted to B for Rs. 2500, C sues B for the debt due by B to A. In this case B is entitled to set off the debt due by A to him (Rs. 2500) although C was unaware of it at the time of such transfer.

The banker should, therefore, accept the assignment of a debt after ascertaining whether any debt is due by the customer to his debtor or not.

5.9 ADVANCES AGAINST GOLD ORNAMENTS AND JEWELLERY

The Reserve Bank has permitted banks to accept gold ornaments for enabling the borrowers to meet their urgent medical expenses and other unforeseen liabilities. In August 1993 a ceiling on such advances was fixed at Rs. 25000. But in February, 1995 banks were permitted to fix their own ceiling company, whether as pledgee, mortgagee or absolute

owner, of an amount exceeding 30% of the paid-up capital of that company or 30% of its paid-up capital and reserves whichever is less”.

5.10 SUMMARY

A banker should observe some basic principles while granting advances against securities offered by customers. These principles are: adequacy of margin, marketability of securities, documentation, and realisation of the advance if the borrower defaults. The advances are generally sanctioned, by the scheduled banks in India, against the security of goods, documents of title to goods, stock exchange securities, life insurance policies, real estate, fixed deposit receipts book debts, and gold ornaments and jewellery.

Goods and commodities as security to the banker offer the advantages of better security, stable prices of necessary goods and easy liquidation. However, a banker should be careful about- (a) whether the goods are adequate security; (b) nature of demand of the goods; (c) valuation of goods; (d) insurance of goods, (d) delivery time and storage facility. The advances against documents of title to goods are subject to some risks, for instance, false description of the goods in the documents of title which are pledged with the banker. The risks in advancing against shares include liability in case of partly paid up shares, company's right of lien on shares, and risks of forgery of share scrips. Thus, almost every kind of security accepted for advances possess some risk. So the banker must be extra-ordinary careful while lending against these securities.

5.11 KEYWORDS

Documents of title to goods: A document of title to goods is a document used in the ordinary course of business as a proof of the possession or control of goods. Bill of Lading, Dock Warrants,

Warehouse-keeper's or wharfinger's certificate, railway receipts and delivery orders are the instances of the documents of title to goods.

Bill of lading: A bill of lading is a document issued by a shipping company acknowledging the receipt of goods for carrying to a specified port. It also contains the conditions for such transportation of goods and full description of the goods, i.e., their markings and contents as declared by the consignor.

Railway receipt: Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is transferable but not a negotiable instrument. It can be transferred by endorsement and delivery.

Stock exchange securities: The term stock exchange securities refers to those securities which are dealt with on the stock exchange.

Trust receipts: The goods or the documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes the borrower wishes to get the security released before he actually repays the loan. In such cases, the banker may, at his discretion, allow the customer to get back the goods or documents and ask the latter to execute a Trust Receipt.

5.12 SELF ASSESSMENT QUESTIONS

1. Describe in detail the usual precautions which a bank should observe when granting advances against the security of (a) immovable property; and (b) manufactured goods.
2. A banker had to advance against an immovable property in Bombay. What preliminary enquiries are to be made before

the advance? What documents are to be taken from the borrower? If the borrower is a limited company, what steps are to be taken to perfect the security?

3. A customer approaches you with a proposal for an advance against an urban immovable property. As Branch Manager, what are the factors which you would examine in considering the proposal? While the advance is sanctioned what documents and safeguards would you take?
4. What precautions should a banker take while making advances against (a) Life Insurance Policies; (b) Commodities; and (c) Fixed Deposit Receipt?
5. As a banker what safeguards would you take while making advances against (a) life insurance policies; (b) debenture stock; (c) hypothecation of tea crop; and (d) government paper.
6. Discuss the suitability of any three of the following as a security for bank advances:
 - (i) Third Party Shares
 - (ii) Inscribed Stock
 - (iii) Equitable Mortgage
 - (iv) Life Insurance Policy
 - (v) Fixed Deposit Receipt of another bank.
7. Discuss the advisability of any two of the following as security for bank advances:
 - (i) Life Policies
 - (ii) Immovable property
 - (iii) Partly paid-up shares
 - (iv) Warehouse receipts

8. State the precautions that must be taken and the practice generally followed by bankers when advancing money against life insurance policies.
9. What are the merits of a Life Insurance Policy as a security for a bank's advance? Describe the formalities to be observed and the safeguards to be adopted when lending against this security.
10. How would you consider an application for advance against (a) book debts; and (b) railway receipt.

5.13 REFERENCES/SUGGESTED READINGS

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Lesson: **6**

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Contracts of guarantees and indemnity

STRUCTURE

- 6.0 Objectives
- 6.1 Introduction to contracts of guarantee
- 6.2 Definition of guarantee
- 6.3 Contracts of indemnity (Definition)
- 6.4 Consideration for guarantee
- 6.5 Distinction between a contract of indemnity and a contract of guarantee
- 6.6 Essential features of a contract of guarantee
- 6.7 Liability of the surety
- 6.8 Rights of surety
- 6.9 Discharge of surety from liability
- 6.10 Reserve bank's guidelines on personal guarantees
- 6.11 Summary
- 6.12 Keywords
- 6.13 Self assessment questions
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6.0 OBJECTIVES

After reading this lesson, you should be able to-

- Explain various provisions of Indian Contract Act, 1972 regarding contracts of guarantees and indemnity;

- Make distinction between contract of guarantee and contract of indemnity;
- Know essential features of a contract of guarantee; and
- Describe liabilities and rights of the surety.

6.1 INTRODUCTION TO CONTRACTS OF GUARANTEE

We must know that contracts of guarantee have special significance in the business of banking as a means to ensure safety of funds lent to the customers. The safety of such funds is primarily ensured by securing a charge over the tangible assets owned by the borrower and/or by the personal security of the latter. But in case a borrower is unable to provide the security of tangible assets or the value of the latter falls below the amount of the loan and the borrower's personal security is not considered sufficient, an additional security is sought by the banker in the form of a 'guarantee' given by a third person. A guarantee is, in fact, the personal security of the third person, who must command the confidence of the banker.

The importance of guarantee as a security for loans granted has greatly increased in recent years. Since the introduction of social control on banks and specially after the nationalisation of major banks, great attention is being paid towards augmenting bank advances for small and neglected borrowers who are unable to provide sufficient tangible assets as security. To safeguard the interests of the lending bankers arrangement has been made of providing guarantees in respect of such advances by the Deposit Insurance and Credit Guarantee Corporation of India.

6.2 DEFINITION OF GUARANTEE

A contract of guarantee is a specific contract and is governed by the provisions of the Indian Contract Act, 1872.

Definition- “A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person in case of his default” (Sec. 126).

A contract of guarantee is entered into with the object of enabling a person to get a loan or goods on credit or an employment.

The person who gives the guarantee is called the ‘surety’; the person in respect of whose default the guarantee is given is called the ‘principal debtor’, and the person to whom the guarantee is given is called the ‘creditor’. A guarantee may be either oral or written (Sec. 126).

Illustrations- A, advances a loan of Rs. 5,000 to B and C promises to A that if B does not repay the loan, C will do so. This is a contract of guarantee. Here B is the principal debtor, A is the creditor and C is the surety or guarantor. It is important that C must stand surety at the request of B, because then only there will be privity of contract between C and B and it will be a contract of guarantee between A and C. If without B’s request C promises to pay on default, it will be a contract of indemnity.

6.3 CONTRACTS OF INDEMNITY (DEFINITION)

“A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a contract of indemnity” (Section 124).

A contract of indemnity is really a part of the general class of ‘contingent contracts.’ It is entered into with the object of protecting the

promissee against anticipated loss. The contingency upon which the whole contract of indemnity depends is the happening of loss.

The person who promises to make good the loss is called the 'indemnifier' (promisor), and the person whose loss is to be made good is called the 'indemnified or indemnity-holder' (promisee).

Illustration- (a The R/R (Railway Receipt) pertaining to certain goods is lost by B. A also claim the goods from Railway Company. In view of the rival claimants of goods, the Railway Company asked A to give an 'indemnity bond'. A, accordingly, gets the goods on executing the 'indemnity bond'. A is the indemnifier and the Railway Company is the indemnity-holder. Later, B, the real owner, sues the Railway Company for damages and gets a decree against the Railway Company. The Railway Company (indemnity-holder) can claim indemnity from A, the indemnifier, for the loss caused to it by his conduct.

Further, a person may undertake to save the other from loss caused to him, by the conduct of a third person either at the request of the third person or without any request from such third person. In the first case there would be a 'contract of guarantee' and the third person would be responsible to the surety. In the latter case there would be a contract of indemnity and the third person (debtor) cannot be held responsible to the indemnifier, as there is 'no privity of contract' between them.

It is to be note that a contract of indemnity, being a species of contract, must have all the essential elements of a valid contract; and an indemnity given under coercion or for an illegal object cannot be enforced. Further, a contract of indemnity may be express or implied. For example, there is an implied promise to indemnify agent by the principal in a contract of agency. Similarly, when shares are transferred the

transferee is impliedly bound to indemnify the transferor against future calls made before the registration of transfer.

Rights of indemnity-holder when sued (Sec. 125)

Let us discuss the rights of indemnity-holder when sued with the help of an example, suppose a vendor contracts to indemnify the vendee against the costs of litigation if title to the property is disturbed, and the vendee is sued by a rival owner, then the vendee i.e., the indemnity-holder has the following rights against the vendor i.e., the indemnifier;

1. Indemnity-holder is entitled to recover all damages which he may be compelled to pay in respect of suit to which the promise to indemnify applies.

2. He is entitled to recover all costs reasonably incurred, in bringing or defending such suit, provided he acted prudently or with the authority of the promisor (indemnifier).

3. He is also entitled to recover all sums which he may have paid under the terms of any compromise of any such suit, provided the compromise was not contrary to the orders of the indemnifier and was prudent or was authorised by the promisor (indemnifier).

In short, the indemnity-holder can recover from the indemnifier, all damages, all costs of the suit and compromise money, if any, provided he acted prudently or with due authority of the indemnifier.

6.4 CONSIDERATION FOR GUARANTEE

A contract of guarantee must also satisfy all the essential elements of a valid contract, e.g., genuine consent, legality of object, competency of parties, etc. It should also be supported by some consideration. But there need be no direct consideration between the surety and the

creditor, and the consideration received by the principal debtor is sufficient for the surety. Section 127 expressly provides to this effect and states that “anything done, or any promise made, for the benefit of the principal debtor, may be a sufficient consideration to the surety for giving the guarantee”.

Illustrations- (a) B requests A to sell and deliver to him goods on credit. A agrees to do so, provided C will guarantee the payment of the price of the goods. C promises to guarantee the payment in consideration of A’s promise to deliver the goods. This is sufficient consideration for C’s promise.

(b) A sells and deliver goods to B, C afterwards requests A to forbear to sue B for the debt for a year, and promises that if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C’s promise.

(c) A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. the agreement is void.

The third illustration to the Section (as reproduced above) implies that a guarantee for a past debt would be invalid. There must be some fresh consideration moving from the creditor at the time of guarantee, e.g., a further advance is made or the creditor refrains from suing the principal debtor on the payment having become due; in order to constitute a valid contract of guarantee. But in the case of a further advance the surety must clearly undertake the liability for the total debt including the past debt.

6.5 DISTINCTION BETWEEN A CONTRACT OF INDEMNITY AND A CONTRACT OF GUARANTEE

The following are the points of distinction between the two:

1. *Number of parties*- In a contract of indemnity, there are two parties- the creditor, the principal debtor and the surety.

2. *Object or purpose*- A contract of indemnity is for the reimbursement of loss, whereas a contract of guarantee is for the security of a debt or good conduct of an employee.

3. *Number of contracts*- In indemnity there is only one contract between the indemnifier and the indemnified, while in guarantee, there are three contracts- one between the principal debtor and the creditor, the second between the creditor and the surety, and the third between the surety and the principal debtor.

4. *Nature of liability*- In a contract of indemnity, the liability of the indemnifier is primary in nature. In a contract of guarantee, the liability of the surety is secondary, i.e., the surety is liable only on default of the principal debtor. (If the principal debtor fulfils his obligation, the question of surety's liability does not arise.).

5. *Request by the debtor*- In a contract of indemnity, the indemnifier acts independently without any request of the debtor or the third party, whereas in a contract of guarantee it is necessary that the surety should give the guarantee at the request of the debtor.

6. *Existing debt or duty*- In a contract of indemnity, in most cases there is no existing debt or duty, whereas in a contract of guarantee there is an existing debt or duty, the performance of which is guaranteed by the surety.

7. *Right to sue*- In a contract of guarantee, the surety, after he discharges the debt owing to the creditor, can proceed against the principal debtor in his own right. But in the case of a contract of

indemnity, the indemnifier cannot sue the third party for loss in his own name, because there is no privity of contract. He can do so only, if there is an assignment in his favour, otherwise he must bring the suit (against the third party) in the name of the indemnified.

6.6 ESSENTIAL FEATURES OF A CONTRACT OF GUARANTEE

1. A contract of guarantee may be either oral or written (Section 126). Bankers invariably like to have a written contract of guarantee to avoid uncertainty in future and to bind the surety by his words.

2. Sometimes a contract of guarantee is implied also from the special circumstances. For example, the endorser of a bill of exchange is liable to pay the amount of the bill to the payee in case the acceptor of the bill defaults to fulfil his promise.

3. A guarantee may be either (i) a specific guarantee, or (ii) a continuing guarantee. A specific guarantee is given in respect of a single transaction or promise undertaken by the principal debtor. It comes to an end when the specific promise or transaction is fulfilled or undertaken.

Example- Punjab National Bank sanctions a loan of Rs. 2,00,000 to Z. A stands as surety for the repayment of the same. This is a specific guarantee. As soon as Z repays the loan to the Bank, A's liability as surety is over. If subsequently Z takes another loan from the same Bank, A will not be deemed as surety for the same.

A guarantee which extends to a series of promises or transactions is called a 'continuing guarantee' (Section 129). The surety specifies the amount up to which and the period within which he shall remain liable as a surety.

Example- A enters into a cash credit arrangement with PNB for a credit limit of Rs. 10,000. C stands as surety for A upto this amount for a period of one year ending 31st December, 1998. Under this arrangement A will be permitted to undertake any number of transactions with the bank subject to the limit that the maximum amount outstanding in his account at any time should not exceed Rs. 10,000. C will remain liable as surety for the actual amount of debt taken by A, but within the limit of Rs. 10,000 and that too within a period of one year.

In case of a continuing guarantee the surety remains liable during the specified period of guarantee. But he can at any time revoke the continuing guarantee as to future transactions, by giving notice to the creditor (Section 130).

Example- In the above example, C can revoke his guarantee at any time during the period of guarantee. Suppose he gives notice of revocation on 1st July, 1998, he will remain liable for the debt due from A to PNB on that day but not in respect of debts granted thereafter.

4. Consideration- A contract of guarantee, like any other valid contract, must have 'consideration'. According to Section 127, "anything done or any promise made for the benefit of the principal debt or may be a sufficient consideration to the surety for giving the guarantee". This implies that the consideration for giving guarantee may not be for the benefit of the surety but for the benefit of the principal debtor. Anything done or any promise made by the creditor in favour of the principal debtor will constitute a valid consideration for a guarantee. The words 'anything done' imply that consideration may be a past consideration also. For example, if the creditor promises not to sue the debtor for the debts due from him, it will be deemed sufficient consideration for a contract of guarantee.

5. Effect of misrepresentation or concealment of material facts- A contract of guarantee is not a contract of utmost good faith. The banker is, therefore, under no obligation to disclose to the surety the past conduct of the debtor or full facts relating to his state of affairs. However, if the surety asks the banker to furnish any such information regarding the debtor, it is the duty of the banker to comply with such request. Normally, the banker takes a letter of consent from the customer to disclose any such information. The banker should furnish such information honestly and with care. A contract of guarantee, like any other contract, must be entered into with the free consent of the parties, i.e., without coercion, undue influence, fraud, misrepresentation or mistake. If the creditor misrepresents certain material facts to the surety or conceals such facts by silence, the guarantee is not deemed as secured by free consent and the contract of guarantee is treated as invalid.

Section 142 of the Indian Contract Act, 1872, lays down that “any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid”. Section 143 states that “any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid”. Thus the creditor is under an obligation not to keep silence about the material facts and not to misrepresent the material facts.

6.7 LIABILITY OF THE SURETY

6.7.1 The extent of liability

According to Section 128, “the liability of the surety is co-extensive with that of the principal debtor, unless otherwise provided by the contract.” This means that the liability of the surety is to the same extent

to which the principal debtor himself is liable to the creditor, provided the surety does not restrict his liability in the contract of guarantee. If the liability of the principal debtor increases, the liability of the surety also goes upto the same extent. For example, A guarantees the repayment of a loan granted by X to Y along with interest due thereon. The liability of the principal debtor increases by the amount of interest which becomes due with the passage of time. The liability of the surety also increases to the same extent. But the liability of the surety cannot, in any circumstances, exceed that of the principal debtor.

The surety may, however, undertake liability for less than the amount of debt of the principal debtor by specifying the same in the contract of guarantee. The extent of guarantee may be limited in either of the following two ways:

- (i) He may guarantee only a part of the entire debt, or
- (ii) He may guarantee the whole of the debt but may specify the amount up to which he makes himself liable to pay to the creditor.

The burden of liability that will fall on the surety will be different in each of the two circumstances.

Examples- (a) Bank of India grants a loan of Rs. 10,000 to Y, Z guarantees the loan to the extent of Rs. 5,000 only.

(b) PNB sanctions a loan of Rs. 10,000 to A. B guarantees the loan with the provision that not more than Rs. 5,000 shall be recoverable from him.

Suppose in both the cases the banks are able to recover one-fourth of the amount of the loan. The amount which they can realise from the sureties in each case shall be determined as follows:

In example (a), the loan is guaranteed to the extent of Rs. 5,000 only. So whatever loss is being suffered by Bank of India in respect of the first Rs. 5,000 of the loan is recoverable from the surety Z. As one-fourth of the entire amount is recovered, the liability of the surety will be to the extent of Rs. 3,750 only (i.e., Rs. 5,000 minus Rs. 1,250 recovered from the debtor in respect of the guaranteed amount of loan, i.e., half of the entire loan). The bank will also realise Rs. 1,250 guaranteed). Bank of India thus recovers the amount of Rs. 6250.

In example (b), the surety has guaranteed the entire debt but has restricted the maximum amount of his liability to Rs. 5,000. The bank realises Rs. 2,500 (one-fourth of the entire debt) from the debtor. The remainder of the loss is Rs. 7,500 (i.e., Rs. 10,000 minus Rs. 2,500). As the surety is liable to pay the maximum amount of Rs. 5,000, which is less than the amount of actual default, the bank can get Rs. 5,00 only from the surety. PNB thus realises Rs. 2,500 plus Rs. 5,00 i.e. Rs. 7,500 in all.

The liability of the surety is not affected by the scheme of compromise sanctioned by the High Court on the petition of the debtor company. In *E.K. Mutukrishna Skthivel Vanavarayar vs. Somasundaram Mills (P) Ltd.* And another (A.I.R. 1973. Madras 463). A deposit of Rs. 15,000 was received by the company which was returnable within a period of one year. Payment of the amount of the deposit, after maturity, was guaranteed by the surety. On default of payment, a decree was passed by the Trial Court against the company and the surety directing them to jointly and severally pay the decretal amount after the expiry of six months from the date of the decree. Thereafter the High Court, on the petition of the company, under which the company became liable to pay its creditors by instalments. The surety contended that the decree-holder could claim payment only in accordance with the provisions of the

scheme and that as the terms of the decree stood modified, the decree-holder had no right to execute the decree for the entire amount.

On appeal, the Madras High Court held that the decree-holder could not, after the sanction of the scheme of compromise, pursue the execution proceedings against the company. However, so far as the surety was concerned, there was nothing in the decree which suspended execution against him. Since the decree passed against the surety was a joint and several decree, he was independently liable and was not entitled to invoke the benefit of Section 391 of the Companies Act.

The liability of the surety remains even if the debt of the principal debtor becomes barred by limitation. Giving this judgement in Punjab National bank and others vs. Surendra Prasad Sinha JT 1992 (3) SC 46, the Supreme Court held that Section 3 of the Limitation Act only bars the remedy, but does not destroy the right which the remedy relates to. The right to debt continues to exist, notwithstanding the remedy is barred by the limitation. The Court was of the view that that right can be exercised in any other manner than by means of a suit.

In this case, a loan taken by X was guaranteed by Y and his wife, who jointly executed the surety bond and entrusted FDR as security to adjust the outstanding debt from it at maturity. After the debt became time barred, the bank appropriated as part of the money payable on the maturity of the FDR towards the payment of the guaranteed debt. The guarantors objected on the plea that as the debt became barred by limitation, their liability being co-extensive with that of the principal debtor, also stood extinguished. The Supreme Court turned down this plea on the ground that the debt was not extinguished; only the remedy to enforce the liability was destroyed.

6.7.2 The time liability arises

The liability of the surety shall arise as soon as the principal debtor makes a default. The creditor need not exhaust all remedies against the principal debtor before recovering the amount from the surety. In other words, the liability of the surety cannot be postponed. In the *Bank of Bihar Limited vs. Damodar Prasad and Another* (Civil Appeal No. 1109 of 1965), the Supreme Court held that “the liability of the surety is immediate and cannot be deferred until the creditor has exhausted his remedies against the principal debtor. A surety has no right, before making payment, to ask the creditor to pursue his remedies against the principal debtor in the first instance. Similarly, he has no right, in the absence of some special equality, to restrain an action against him by the creditor on the ground that the principal debtor is solvent or that the creditor may have relief against the principal debtor in some other proceedings. It is the duty of the surety to pay the decretal amount”.

The liability of surety may, however, be postponed, if the agreement contains a specific clause to this effect. However, the liability of the surety does not arise unless the liability of the principal debtor is determined. In *Punjab National Bank Ltd. Vs. Shri Vikram Cotton Mills Ltd. and Another* (A.I.R. 1970, Supreme Court 1973), the surety agreed to pay on demand all money which may be due as ultimate balance from the company (principal debtor) to the bank. The Allahabad High Court sanctioned a scheme of composition in the winding up proceedings of the company at the instance of some of the creditors. The bank sued the company and the guarantor. On appeal, the Supreme Court held that unless and until the ultimate balance was determined, no liability of the surety to pay the amount would arise.

6.7.3 Liability of co-sureties

When more than one person guarantee a debt, all of them are called co-sureties and are liable to pay the debt of the principal debtor. If one of them has paid the entire amount to the creditor, he is entitled to claim contribution from his co-sureties. Sections 146 and 147 provide for the determination of the liability of co-sureties as follows:

(a) “Where two or more persons are co-sureties for the same debt or duty, either jointly or severally and whether under the same or different contracts, and whether with or without the knowledge of each other, the co-surities, in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor (Section 146).

The co-sureties are liable to contribute equal amounts towards the liability of the debtor, provided:

- (i) there is no agreement to the contrary; and
- (ii) they are co-sureties for the same amount of debt.

It is immaterial whether the contract or guarantee was the same or separate between each one of them and the creditor and whether they knew about the guarantee given by the other person or not.

Examples- (1) SBI grants a loan of Rs. 5,000 to Yon the guarantee of A, B and C. On the date it is able to recover Rs. 2,000 only from Y. The three co-sureties A, B and C are liable, as between themselves to pay Rs. 1,000 each.

If, in the above example, here is an agreement between the co-sureties that A will be liable to pay 50% of the amount of default and B and C will each contribute 25% of the amount of such default, the liability of A will be to the extent of Rs. 1,500, while B and C will pay Rs. 750 each.

(b) “Co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit (Section 147)”. Thus if the co-sureties have guaranteed a loan upto different limits, each of them will be liable to contribute equally provided their own contribution does not exceed the amount for which guarantee is undertaken by them individually.

Examples- (1) A has taken a loan of Rs. 7,000 from PNB. C has guaranteed it for Rs. 4,000, D for Rs. 4,00 and E for Rs. 1,000 separately. On due date PNB recovers Rs. 1,000 only from A. The remainder of the amount Rs. 6,000 is recoverable from the three sureties equally (i.e., Rs. 2,000 each), but as E guaranteed the loan upto Rs. 1,000 only, he is liable to pay Rs. 1,000 only. The balance of Rs. 5,000 will be contributed by C and D equally (i.e. Rs. 2,500 each).

6.7.4 Revocation of continuing guarantee

A continuing guarantee may be revoked as regards future transactions under the following circumstances:

1. By notice of revocation by the surety- Section 130 provides that “a continuing guarantee may, at any time, be revoked by the surety, as to future transactions, by notice to the creditor”. Thus the surety, may terminate his continuing guarantee as regards transactions entered into after the notice. He continues to be liable for transactions entered into prior to the notice.

Illustration- A, in consideration of B’s discounting, at A’s request, bill of exchange for C, guarantees to B, for twelve months, the due payment of all such bills to the extent of Rs. 5,000. B discounts bills for C to the extent of Rs. 2,000. Afterwards, at the end of three months A revokes the guarantee. This revocation discharges A from all liabilities to

B for any subsequent discounting of bills. But A is liable to B for Rs. 2,000, on default of C.

2. By death of surety- Section 131 lays down that “the death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions”. Accordingly, a continuing guarantee is also terminated by the death of the surety so far as regards future transactions unless there is a contract to the contrary. It is not necessary that the creditor must have notice of the death. The estate of the surety is free after death, although the creditor might have entered into a transaction without knowledge of the death of the surety.

3. In the same manner as the surety is discharged- A continuing guarantee is also revoked under the same circumstances under which a surety’s liability is discharged, that is:

- (a) By variance in terms of contract (Section 133).
- (b) By release or discharge of principal debtor (Section 134).
- (c) By arrangement with principal debtor (Section 135).
- (d) By creditor’s act or omission impairing surety’s eventual remedy (Section 139).
- (e) By loss of security (Section 143).

6.8 RIGHTS OF SURETY

A surety has certain rights against the creditor, principal debtor and co-sureties.

Surety’s rights against the creditor- The surety enjoys the following rights against the creditor:

1. *Right to benefit of creditor’s securities (Section 141)-*

The surety is entitled to demand from the creditor, at the time of payment, all the securities which the creditor has against the principal debtor at the time when the contract of suretyship is entered into or subsequently acquired. Whether the surety knows of the existence of such security or not is immaterial. If by negligence the creditor loses or, without the consent of the surety, parts with much security as acquired at the time of contract, the surety is discharged to the extent of the value of security. But if the security is lost due to an act of God or enemies of the State or unavoidable accident, the surety would not be discharged (*Krishan Talwar vs. Hindustan Commercial Bank*). Similarly, if the subsequently acquired securities are parted with, the liability of the surety would not be reduced (*Bhushaya vs Suryanarayan*).

It is to be remembered that the surety is entitled to the benefit of the securities only after paying the debt in full. He cannot claim the benefit of a part of the securities merely because he has paid a part of the debt (*Goverdhandas vs Bank of Bengal*).

Illustrations (appended to Section 141). (a) C advances to B, his tenant, Rs. 2,000 on the guarantee of A, C has also a further security for the 2,000 rupees by a mortgage of B's furniture, C cancels the mortgage, B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture.

(b) C, a creditor, whose advance to B is secured, by a decree, receives also a guarantee for that advance from A. C afterwards takes B's goods in execution under the decree, and then, without the knowledge of A withdraws the execution. A is discharged.

2. *Right to claim set-off, if any*

The surety is also entitled to the benefit of any set-off or counter claim, which the principal debtor might possess against the creditor in respect of the same transaction.

Surety's rights against the principal debtor- The surety enjoys the following two rights against the principal debtor:

1. *Right of subrogation (Section 140)*

When the surety pays off the debt on default of the principal debtor, he is invested with all the rights which the creditor had against the principal debtor. The surety steps into the shoes of the creditor and is entitled to all the remedies which the creditor could have enforced against the principal debtor. The surety may therefore, claim the securities, if any, held by the creditor and sue the principal debtor, or may claim dividend in insolvency of the debtor.

2. *Right to claim indemnity (Section 145)*

“In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the principal debtor whatever sum he has ‘rightfully paid’ under the guarantee, but no sums which he had paid wrongfully”. Thus a surety is entitled to be indemnified by the principal debtor for whatever sum he has ‘rightfully paid’ under the guarantee.

The expression ‘rightfully paid’ means a just and equitable payment. It covers the principal sum, interest thereon, noting charges in case of a bill of exchange, and costs of the suit if there are reasonable grounds to defend the suit. It does not cover unjust payment like the payment made of a debt which is time barred as against both the principal debtor and surety.

The following two points claim more than what he has actually paid to the creditor. Thus if he discharges the debt by compromise at less than its full amount, he can get from the principal debtor only the amount actually paid.

(a) Actual payment either in cash or by transfer of property is essential for asking the principal debtor to pay. A promissory note given by the surety will not be sufficient to claim indemnity.

Illustrations. (a) B is indebted to C, and A is surety for the debt. C demands payment from A, and on his refusal sues him for the amount. A defends the suit, having reasonable grounds for doing so (some variation in terms later might be A's plea), but is compelled to pay the amount of the debt with costs. He can recover from C the amount paid by him for costs, as well as the principal debt.

(b) C lends B a sum of money, and A, at the request of B, accepts a bill of exchange drawn by B upon A to secure the amount. B then endorses the bill to C. C, the holder of the bill, demands payment of it from A, and on A's refusal to pay, sues him upon the bill. A, not having reasonable grounds for so doing, defends the suit and has to pay the amount of the bill and costs. A can recover from B the amount of the bill, but not the sum paid for costs, as there was no real ground for defending the action.

Surety's rights against co-sureties- Where a debt is guaranteed by more than one sureties, they are called co-sureties. In such a case all the co-sureties are liable to contribute towards the payment of the guaranteed debt as per agreement among them. But in the absence of any agreement, if one of the co-sureties is compelled to pay the entire debt, he has a right of contribution from the other co-surety or

co-sureties. The rules of contribution are laid down in Section 146-147, which are as follows:

1. Where they are sureties for the same debt for similar amount (i.e., for one and the same amount), the co-sureties are liable to contribute equally, and are entitled to share the benefit of securities, if any, held by any one of the co-sureties, equally. To sum up the principle it may be said, "As between co-sureties, there is equality of burden and benefit". Further, for the application of the principle it is immaterial whether the sureties are liable jointly under one contract or severally under several contracts, and whether with or without the knowledge of each other. There is, however, no right of contribution between persons who become sureties not for the same debt but for different debts.

Illustrations (appended to Section 146). (a) A, B and C are sureties to D for the sum of Rs. 3,000 lent to E. E makes default in payment. A, B and C are liable, as between themselves, to pay Rs. 1,000 each. (If C is insolvent and could pay only Rs. 500, then A and B will contribute equally to make good his loss).

2. Where they are sureties for the same debt for different sums, the rule is that "subject to the limit fixed by his guarantee, each surety is to contribute equally, (and not proportionately to his liability undertaken)."

Illustration- (appended to Section 147). A, B and C as sureties for D, enter into three several bonds each in a different penalty, namely, A in the penalty of Rs. 10,000, B in that of Rs. 20,000 and C in that of Rs. 40,000, conditioned for D's duly accounting to E. Then,

- (i) If D makes default to the extent of Rs. 30,000, A, B, and C are each liable to pay Rs. 10,000;

- (ii) if D makes default to the extent of Rs. 40,000, A is liable to pay Rs. 10,000 (his maximum limit of liability), and B and C Rs. 15,000 each;
- (iii) if D makes default to the extent of Rs. 60,000, then A is liable to pay Rs. 10,000, B Rs. 20,000 and C Rs. 30,000; and
- (iv) if D makes default to the extent of Rs. 70,000, then A, B and C have to pay each the full penalty of his bond.

6.9 DISCHARGE OF SURETY FROM LIABILITY

A surety is freed from his obligation under a contract of guarantee under any one of the following circumstances:

1. Notice of revocation- An 'ordinary guarantee' for a single specific debt or transaction cannot be revoked once it is acted upon. But a 'continuing guarantee' may at any time, be revoked by the surety as to future transactions, by giving notice to the creditor (Sec. 130). Thus, in such a case, the liability of the surety comes to an end in respect of future transactions, which may be entered into by the principal debtor after the surety has served the notice of revocation. The surety shall, however, continue to remain liable for transactions entered into prior to the notice.

2. Death of surety (Sec. 131)- In case of a 'continuing guarantee' the death of a surety also discharges him from liability as regards transactions after his death, unless there is a contract to the contrary. The deceased surety's estate will not be liable for any transaction entered into after the death, even if the creditor has no notice of the death.

3. Variance in terms of contract (Sec. 133)- "Any variance, made without the surety's consent in the terms of the contract between

the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance.” Although the words “as to transactions subsequent to the variance” are more pertinent in the case of continuing guarantee’, but the principle as laid down in the Section is equally applicable in ‘specific guarantee’ as well. Thus a surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor (no matter whether the variation is beneficial to the surety or is made innocently or does not materially affect the position of the surety) because a surety is liable only for what he has undertaken in the contract. “Surety has a right to say: The contract is no longer that for which I engaged to be surety; you have put an end to the contract that I guaranteed, and my obligation, therefore, is at an end.” It is important to note that mere knowledge and silence of the surety does not amount to an implied consent (Polak vs Everett). Again, accepting further security for the same debt is not treated as variance in terms of contract.

Illustrations (appended to Sec. 133)- (a) A becomes surety to C for B’s conduct as a manager in C’s bank. Afterwards, B and C contract, without A’s fourth of the losses on overdrafts. B allows a customer to overdraw, and the bank loses a sum of money. A is discharged from his suretyship by the variance made without his consent, and is not liable to make good this loss.

4. Release or discharge of principal debtor (Sec. 134)- This Section provides for the following two ways of discharge of surety from liability:

- (a) The surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released. Any release of the principal debtor is a release of the surety also.

- (b) The surety is also discharged by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.

Illustrations- A gives a guarantee to C for goods to be supplied by C to B. C supplies goods to B, and afterwards B becomes embarrassed and contracts with his creditors (including C) to assign to them his property in consideration of their releasing him from their demands. Here B is released from his debt by the contract with C, and A is discharged from his suretyship.

5. Arrangement by creditor with principal debtor without surety' consent (Sec. 135)- Where the creditor, without the consent of the surety, makes an arrangement with the principal debtor for composition, or promises to give him time or not to sue him, the surety will be discharged. But in the following cases, a surety is not discharged:

- (a) Where a contract to give time to the principal debtor is made by the creditor with a third person, and not with principal debtor, the surety is not discharged (Sec. 136).

Illustration- C, the holder of an overdue bill of exchange drawn by A as surety for B and accepted by B, contracts with M to give time to B. A is not discharged.

- (b) Mere forbearance on the part of the creditor to sue the principal debtor, or to enforce any other remedy against him, does not discharge the surety, unless otherwise agreed (Sec. 137).

Illustration- B owes to C a debt guaranteed by A. The debt becomes payable, C does not sue B for a year after the debt has become payable. A is not discharged from the suretyship.

- (c) Where there are co-sureties, a release by the creditor of one of them does not discharge the others; neither does it free the surety so released from his responsibility to the other sureties (Sec. 138).

6. Creditor's act or omission impairing surety's eventual remedy (Sec. 139)- "If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged." In short, it is the duty of the creditor to do every act necessary for the protection of the rights of the surety and if he fails in his duty, the surety is discharged. Thus, where the integrity of a cashier is guaranteed, it is the duty of the employer to give information to the surety if any dishonest act is done by the employee. If the employer continues to employ him after an act of dishonesty (which is proved), the surety is discharged, if he is not informed within a reasonable time, because then the surety's right (eventual remedy) to inform police for necessary recovery action is lost or damaged i.e., may not be so fruitful as it would have been, had a report been lodged earlier.

Illustrations- (a) B contracts to build a ship for C for a given sum, to be paid by instalments as the work reaches certain stages, (the last instalment not to be paid before the completion of the ship). A becomes surety to C for B's due performance of the contract. C, without the knowledge of A, prepays to B the last two instalments. A is discharged by this prepayment.

- (b) A puts M as an apprentice to B and gives a guarantee to B for M's fidelity. B promises on this part that he will, at least once a month, see M make up the cash. B omits to see this

done as promised, and M embezzles. A is not liable to B on his guarantee.

7. Loss of security (Sec. 14)- If the creditor loses or, without the consent of the surety, parts with any security given to him, at the time of the contract of guarantee, the surety is discharged from liability to the extent of the value of security. The word 'loss' here means loss because of carelessness or negligence. Thus if the security is lost due to an act of God or enemies of the state or unavoidable accident, the surety would not be discharged. Again, if the securities lost or parted with, were obtained afterwards as a further security, the surety would not be discharged (*Bhushaya vs Suryanarayan*).

8. Invalidation of the contract of guarantee (in between the creditor and the surety)- A surety is also discharged from liability when the contract of guarantee (in between the creditor and the surety) is invalid. A contract of guarantee is invalid in the following cases:

- (i) Where the guarantee has been obtained by means of misrepresentation or fraud or keeping silence as to material part of the transaction, by the creditor or with creditor's knowledge and assent (Secs. 142 and 143). Notice that under these Sections the guarantee remains valid if the misrepresentation or concealment is done by the debtor without the concurrence of the creditor.

Illustrations- (a) A engages B as clerk to collect money for him. B fails to account for some of his receipts, and A, in consequence, calls upon him to furnish security for his duty accounting. C gives his guarantee for B's duty accounting. A does not acquaint C with B's previous conduct. B afterwards makes default. The guarantee is invalid.

6.10 RESERVE BANK'S GUIDELINES ON PERSONAL GUARANTEES

A review of practices of commercial banks regarding personal guarantees taken from directors and other managerial personnel of borrowing concerns at the time of sanctioning loans conducted by the Reserve Bank revealed that in some cases, the guarantees had been taken essentially to make up for the insufficiency of tangible security offered or the weak financial position of the borrowing concern; in other cases, guarantees had been taken as a matter of routine even where the financing institutions possessed the security of the company's tangible assets. Banks feel that with the signing of the guarantees, the personal interest of the directors and other managerial personnel in the company is strengthened and hence continuity of good management in future may reasonably be expected.

In the view of the Reserve Bank of India the practice of taking guarantees in all cases is not necessary because of the following changed circumstances;

- (i) There has been gradual rise of an entrepreneurial class in place of the Managing Agency System and the managerial cadres have been professionalised;
- (ii) Financially sound units are able to offer adequate security for meeting their banking needs; and
- (iii) The techniques of financial and technical appraisal by the lending institutions have improved.

In 1970, the Reserve Bank of India had issued detailed guidelines to commercial banks as regards personal guarantees from the directors. Guarantees should be obtained only in circumstances absolutely warranted after a careful examination of the circumstances of each case

and not as a matter of course. Detailed credit analysis should be undertaken by the banks to determine the need for guarantees. The following broad considerations may be taken into account in this connection:

- (a) Guarantees need not be considered necessary in the following cases:
 - (i) Ordinarily in case of public limited companies no personal guarantee need be insisted upon if the lending institutions are satisfied about the management, its state in the concern, economic viability of the personal and the financial position and capacity for cash generation. In case of widely owned public limited companies, which may be rated as first class and which satisfy the above conditions, guarantees may not be necessary even if the advances are unsecured.
 - (ii) In case of companies- private or public- which are under professional management, guarantees may not be insisted upon from persons who are connected with the management solely by virtue of their professional/technical qualifications and not consequent upon any significant shareholding in the company concerned.
 - (iii) Where the lending institutions are not convinced about the above-mentioned aspects of loan proposals they should seek to stipulate conditions to make the proposals acceptable without such guarantees. In some cases, more stringent forms of financial discipline like restrictions on distribution of dividends, further expansion aggregate borrowings, creating of

further charge on assets and stipulation of maintenance of minimum net working capital may be necessary. The parity between owned funds and capital investment and the overall debt-equity ratio may have to be taken into account.

- (b) Necessity of guarantee- The Reserve Bank has indicated that guarantees may be considered helpful in the following cases:
- (i) Closely held companies- the guarantee should preferably be that of the principal members of the Group holding shares in the borrowing company;
 - (ii) in case of other companies in order to ensure continuity of management;
 - (iii) public limited companies other than first class companies where advances are on an unsecured basis;
 - (iv) public limited companies, whose financial position and/or capacity for cash generation is not satisfactory even though the advances are secured;
 - (v) in case where considerable delay in the creation of a charge on assets is likely;
 - (vi) the guarantee parent companies in the case of subsidiaries whose own financial condition is not considered satisfactory; and
 - (vii) where the balance sheet or financial statement of a company discloses interlocking of funds between the company and other concerns owned or managed by a group.

Other instructions-

- (a) The guarantees should bear reasonable proportion to the estimated worth of the person.

- (b) Banks should obtain an undertaking from the borrowing company as well as from the guarantor that no consideration in the form of commission, brokerage, fees, etc., will be paid by the company to the guarantor directly or indirectly.

Keeping in view the increasing loan losses being suffered by the banks on account of sticky or stagnant accounts due to industrial sickness, the Reserve Bank advised the banks (July 1986) as follows;

- (a) The banks may, at their discretion, obtain guarantees from directors (excluding the nominee directors) and other managerial personnel in their individual capacities, whenever they consider it necessary.
- (b) in cases where a guarantee is not considered expedient by the bank at the time of sanctioning an advance, an undertaking should be obtained from individual directors and a covenant should be included in the loan agreement that in case the borrowing unit shows cash losses or adverse current ratio or diversion of funds, the directors would execute guarantees in their individual capacities, if required, by the banks.
- (c) Banks may also obtain guarantees at their discretion from parent holding company, when credit facilities are extended to borrowing units in the same group.

The Reserve Bank further advised the banks that ordinarily banks need not insist on personal guarantees from professional managers/directors except in cases where they have a significant shareholding in the company. If the management commits serious malpractices, the right remedy would be to have them removed or replaced.

6.11 SUMMARY

The contracts of guarantee have special significance in the business of banking as a means to ensure safety of funds lent to the customers. An additional security (i.e. in addition to a charge over the tangible assets owned by the borrower) is sought by the banker in the form of a 'guarantee' given by a third party. This third person must command the confidence of the banker. In a contract of indemnity, the person who promises to make good the loss is called the 'indemnifier' and the person whose loss is to be made good is called the 'indemnified. Further, a person may undertake to save the other from loss caused to him, by the conduct of a third person either at the request of the third person or without any request from such third person. In the first case there would be a 'contract of guarantee' and in the latter case there would be a contract of indemnity and the third person (debtor) cannot be held responsible to the indemnifier as there is 'no privity of contract' between them. Indemnity holder is entitled to recover all damages which the promise to indemnity applies.

6.12 KEYWORDS

Contracts of guarantee: A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person in case of his default" (Sec. 126 of Indian Contract Act, 1872).

Contract of indemnity: A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a contract of indemnity (Section 124 of Indian Contract Act, 1872).

Continuing guarantee: A guarantee which extends to a series of promises or transactions is called a 'continuing guarantee' (Section 129 of Indian Contract Act, 1872).

Surety: The person who gives the guarantee is called the 'surety'; the person in respect of whose default the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'.

Co-surety: When more than one person guarantee a debt, all of them are called co-sureties and are liable to pay the debt of the principal debtor.

6.13 SELF ASSESSMENT QUESTIONS

1. Discuss, giving examples, the obligations of the banker in a contract of guarantee.
2. Explain the distinction between a Guarantee and an Indemnity. Which of these is a better security for the lending banker?
3. State the precautions a banker should take in granting loans against guarantees.
4. Explain a contract of guarantee and a contract of indemnity. Distinguish between them. What are the rights and liabilities of the surety and the banker in a contract of guarantee?
5. Discuss the mutual rights of the banker and the surety in a contract of guarantee.
6. As a lending banker who has to keep in mind, among other factors, the contingency of the principal debtor becoming insolvent, which of the following two forms of guarantee would you consider more advantageous to him?
 - (i) A guarantee for a customer's liabilities, present and future, up to the extent of Rs. 10,000

OR

- (ii) a guarantee for a customer's liabilities, present and future, with a provision that not more than Rs. 10,000 shall be recoverable from the guarantor. Clarify your answer with reasons and examples.
7. Discuss the nature and extent of surety's liability.
8. What is a continuing guarantee? When and how is revoked?
9. State and explain the circumstances under which a surety is discharged from his liability.
10. A contracts to indemnify B against the consequences of proceedings which C may take against B in respect of a certain sum of money. C obtains judgement against B for the amount. Without paying any portion of the decree amount, B sues A for its recovery. Will B succeed?
11. A is employed as a cashier on a salary of Rs. 2,000 a month by a bank for a period of three years, C standing surety for A's good conduct. Nine months afterwards, when the financial position of the bank deteriorates, A agrees to accept a lower salary of Rs. 1,500 a month. Two months later, it is discovered that A has been misappropriating cash all through. What is the liability of C?
[Hint. C is liable as a surety for the loss suffered by the bank due to misappropriation by A during the first nine months but not for misappropriations committed after the reduction in salary. [See illustration (c) to Sec. 133]

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CAPITAL ADEQUACY AND NPAS IN BANKS

STRUCTURE

- 7.0 Objectives
- 7.1 Introduction
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- 7.3 Approaches to Capital Adequacy
- 7.4 Capital Regulation and Shareholder Wealth
- 7.5 The Capital-Assets Ratio (or Leverage Ratio)
- 7.6 Guidelines of RBI for Capital Adequacy
- 7.7 Measures to Improve Capital Adequacy
- 7.8 Non Performing Assets (NPA) in Banks
- 7.9 Summary
- 7.10 Keywords
- 7.11 Self Assessment Questions
- 7.12 References/Suggested readings

7.0 OBJECTIVES

After reading this lesson, you should be able to-

- Define bank capital;
- Explain the various components of capital;
- Explain the methodology to determine capital adequacy;
- Explain the regulatory guidelines on capital adequacy; and
- Understand NPA problem in Indian Banks.

7.1 INTRODUCTION

Capital is essential and critical to the perpetual continuity of a bank as a going concern. A minimum amount of capital is required to ensure safety and soundness of the bank and also to build trust and confidence of the customers. In the course of their operations banks face risks and potential losses. The banking regulators as well as banks have put in place effective controls and risk management strategies to minimise these risks. The process has been evolving over a period of time. As risks in banks have grown over the years, the regulators have been prescribing various types of requirements to take care of the risks and the likely losses arising out of them. The Capital Adequacy Requirement (CAR) on credit risks prescribed by every national regulator is a case in example.

Bank capital generally refers to the funds contributed by the shareholders or owners consisting of common stocks, reserves and retained earnings. It is also called the net worth of a bank.

Common stock: It represents the par value of common equity shares contributed by shareholders.

Reserves & Surplus: It constitutes undistributed profits and other inflows earmarked for specific purposes like: (i) cash reserve as stipulated by Reserve Bank of India, (ii) statutory reserve, i.e. a part of profit transferred to reserves and (iii) share premium account, i.e. the premium paid by shareholders in excess of the par value of the stocks.

Balance in Profit & Loss account: It is the part of the retained earnings that remains in the business after transfer to reserves.

Loan Loss reserves: It is the reserve created out of the total earnings before arriving at net profit and earmarked against possible loan losses.

Subordinated long-term debt: The subordinated debt is a major component of capital because it is convenient to raise and is relatively cheaper compared to common stock. Banks raise such debts to meet the regulatory capital requirement. The repayment is subordinated to the claims of other depositors and creditors. However, in case of bankruptcy, it has priority over common equity.

7.2 CAPITAL ADEQUACY IN INDIAN BANKS

Capital Adequacy provides protection to depositors and other creditors in the event their assets decline in value or the financial institution suffer losses. There are several definitions of capital depending on the regulatory agency involved. Some of these measures include loan loss reserves, redeemable preferred stock and certain qualified debt instruments.

Capital Adequacy relates to the firm's overall use of financial leverage. It also measures the relationship between firm's market value of assets and liabilities and the corresponding book value. Not all source of capital show up on the firm's balance sheet. For example, a firm might have a large loan-servicing unit that has been built over many years and that has a market value substantially in excess of its book value. The reverse is also possible. A firm might have portfolio of securities that when marked-to-market falls far below the firm's book value.

The adequacy of firm's capital depends on many variables. For example, it would be considered appropriate for a financial firm to have more capital, everything else held constant, in the following circumstances:

- The institution has a high percentage of risky assets.
- The institution has a large unmatched interest rate risk position.
- The institution employs a high percentage of wholesale funding sources.
- The institution lacks diversification of assets by having a high concentration of assets in a few markets.

The net worth to total assets ratio tells us about the firm's overall financial leverage relating to those assets held on the balance sheet. The higher the ratio, the lower the financial risk of the company.

In this lesson, we focus by and large on the first three functions concerning the role of capital in reducing insolvency risk; however, first, we glance at the fourth function equity capital and its cost as funding source.

Capital and Insolvency Risk: To see how capital protects a financial institution against insolvency risk, we have to define capital more precisely. The problem is that there are many definitions of capital, what an economist defines as capital may differ from an accountant's definition, which in turn can differ the definition used by regulators. Specifically, the economic definition of a bank's capital or owner's equity stake a financial institution (F.I.) is the difference between the market values of its assets and its liabilities.

This is also called the net worth of an FI. While this is the economic meaning of capital, regulators have found it necessary to adopt

different definitions of capital that depart by some greater or lesser degree from economic net worth. The concept of an FI's economic net worth is really a market value accounting concept. The concept of an FI's economic net worth is really a MVAAC with the exception of the investment banking industry regulatory defined capital and required leverage ratios are based in whole or in part on historical or book value accounting concepts.

We begin by taking a look at the role of economic capital or net worth as an institution device against two major types of risk: Credit risk and Interest rate risk. We then compare this market value concept with the book value concept of capital. Because it can actually distort the true solvency position of an FI, the book value of capital concept can be misleading to managers, owners liability holders and regulators alike.

The Market Value of Capital: To see how economic net worth or equity insulates an FI against risk, consider the following example:

In given example we have a simple balance sheet, where all the assets and liabilities of a financial Institution are valued in market value terms at current prices on a mark-to-market basis. On a mark-to-market or market value basis, the economic value of the financial institution's equity is \$10 million, which is the difference between the market value of its assets and liabilities. On a market value basis, the financial Institution is economically solvent and would impose no failure costs on depositors or regulators if it were to be liquidated today. Let us consider the impact of two classic types of financial risk on this FI's net worth credit risk and interest rate risk.

TABLE 7.1: FI's MARKET VALUE BALANCE SHEET (\$MILLIONS)

LIABILITIES	ASSETS
Liabilities (short-term) \$90	Long Term Securities

		\$80
Net Worth \$10		Long Term Loans \$20
Total	\$100	Total \$100

Market Value of Capital and Credit Risk: In the above balance sheet 1 an FI has 20 million in long-term loans. Suppose that due to recession, a number of these borrowers get into cash flow problems and are unable to keep up their promised loan repayment schedules.

TABLE 7.2: THE MARKET VALUE BALANCE SHEET AFTER A DECLINE IN THE VALUE OF LOANS (\$ MILLION)

LIABILITIES		ASSETS	
Liabilities (short-term)	\$90	Long Term Securities	\$80
Net Worth	\$2	Long Term Loans	\$12
Total	\$92	Total	\$92

A decline in the current and expected future cash flows on loans lowers the market value of the loan portfolios held by the FI below 20. Suppose that loans are really worth only 12 that mean the market value of the loan portfolio has fallen from 20 to 12. Look at the revised market value balance sheet 2. The loss of eight in the market value of loans appears on the liabilities side of the balance sheet as a loss of eight to an FI's net worth. That is the loss of assets value is charged against the equity owner's capital or net worth. As you can see, the liability holders are fully protected in that the total market value of their claims is still 90. This is because debt holder is a senior claimant and equity holders are junior claimants. That is because debt holders bear losses on the assest-protfolio first

Market value of Capital and Interest Rate Risk: Consider the same market value balance sheet in table 1 after a rise in interest rates. As we discuss earlier rising interest rate reduce the market value of the

bank's long-term fixed income securities and loans while floating rate instruments. If instantaneously reprised find their market value largely unaffected. Suppose that the rise in interest rate risk reduce the market value of the FI's long-term securities investments from 80 to 75 and the market value of its long-term loans from 20 to 17. Because all deposit liabilities are assumed short-term floating rate deposits, their market values are unchanged at 90. After shock to interest rates, the market value balance sheet might look as in following table: -

TABLE 7.3: THE MARKET VALUE BALANCE SHEET AFTER A RISE IN INTEREST RATES (\$ MILLIONS)

LIABILITIES		ASSETS	
Liabilities (short-term) \$90		Long Term Securities \$80	
Net Worth\$ 2		Long Term Loans \$12	
Total	\$92	Total	\$92

7.3 APPROACHES TO CAPITAL ADEQUACY

Let us discuss the different approaches to capital adequacy in modern times:

Ratio Approaches to Capital Adequacy: Ratio approaches are among the oldest methods of capital adequacy analysis and are still widely used by both managers and regulators. Ratio standards are generally expressed in terms of the ratio to total assets. Ratio standards may be developed for equity capital, primary capital or total capital.

A traditional approach to developing ratio standards is to use judgment to set a level of capital that is believed to provide a reasonable cushion in light of experience. Judgment may be supplemented by studies of past failures. For example, we might look at the failure percentage over a number of five-year periods and study the relationship

between failure clearing each five-year period and capital ratios at the beginning of that that five-year period.

When regulators are developing ratio standards, they are more interested in the solvency of banking system than in single financial institutions. Further more, they want rules that are simple to explain and that provide usable standard for monitoring performance. Regulators may study past failure experience of banks to determine capital ratios that will keep failures at an acceptable level. While there may be, various idea of an acceptable level is that deposit insurance agencies such as the FDIC will be able to make good in their deposit guarantees.

Risk Based Capital Asset Approaches: Proposals for risk-based capital standards have been around for years and are getting increased attention. Regulators in the United States and Great Britain worked jointly to develop a standard in 1987. Under the proposal being developed, off balance sheet claims such as credit guarantees would also be given a weight and added to actual assets. A risk weighted asset base would be developed in this way, and capital requirements would then be a percentage of that risk weighted asset base.

The appeal of the risk-based approach is that it is a step forward from simply looking at total assets in terms of risk-ness. The risk-based approach also has the advantage of requiring capital to support off balance sheet source of risk such as loan guarantees.

Portfolio Approaches to Capital Adequacy: Portfolio approaches to capital adequacy are based on recognition of the complex set of intersections involved in a financial institution. These approaches specifically recognize the fact that two independent risky actions may be combined to create a position that is less risky than either of the independent positions. A bank that has matched the maturates or

reprising dates of its assets and liabilities is less risky than an institution with the same asset base and a large interest rate gap. As another example, suppose one institution specializes in commercial loans while the other specializes in consumer loans. If these two institutions merge, total risk goes down, particularly from the viewpoint of insurance agencies such as the FDIC. The profitability of consumer and commercial loans are not perfectly correlated so profitability in one area may be used to offset low profits in the other area. Like wise international lending provides diversification.

7.4 CAPITAL REGULATION AND SHAREHOLDER WEALTH

Finance theory suggests that there should be an optional mix of debt and equity, which minimizes the required return and maximizes the wealth of the shareholders. The optimal mix is based on considerations of taxes, risk, agency costs and information asymmetry.

Many bankers are of the view that they should operate with lower levels of equity than is commonly the practice and would do so if the regulators did not interfere. This conclusion comes partly from the fact that lower equity ratio provides a higher return on equity for a profitable business. In a recent study, Smith and Heggstad attempted to empirically test the relationship between value and equity capital ratios for large banks. They found that most large banks were undercapitalized from the shareholders perspective and could increase the wealth of the shareholders by carrying more equity than the minimum required satisfying regulators.

Required Return for Depository Institutions: The capital policy of a financial institution has important implications for the required return that must be earned on assets if the institution is to satisfy its stockholders. Required return share is affected by the nature of the

assets, by the institutions operating costs by the form of liabilities as well. An understanding of required return is vital for pricing decisions such as loan and deposit interest rate, as well as for evaluation of potential new product offerings. An understanding of required returns is also vital for the development of capital policy and liability structure.

Several important factors affect the institutions required return. Required return is an opportunity cost or the return that investors and depositors could expect from alternative opportunities of equal risk. One factor in the cost of funds is the general level of opportunities which influence^{4s} the overall level of competitive interest rates. Second investors must expect a higher rate of return if they are to persuade to invest in assets subject to higher risk.

Deposit funds to the extent insured, are essentially risk-free, financial institutions derive funds through insurance of securities and creation of liabilities, many of which are not covered or are covered only partly by insurance examples of these are larger certificates of deposit commercial paper, capital notes and debentures federal funds borrowed Euro preferred stock and common stock. The required return for such funds will increase as perceived risk in the asset and liability structure increases.

7.5 THE CAPITAL-ASSETS RATIO (OR LEVERAGE RATIO)

The capital assets or leverage ratio measures the ration of a bank's book value of primary or core capital to its assets. The lower this ratio the more leveraged it is primary or core capital is a bank's common equity (book value) plus qualifying cumulative perpetual preferred stock plus minority interests equity accounts of consolidated subsidiaries.

With the passage of the FDIC Improvement action 1991, a bank's capital adequacy is assessed according to where its leverage ratio (L) falls in one of five target Zones. The leverage ratio is: $L = \text{Core Capital} / \text{Assets}$

Risk Based Capital Ratios: In light of the weaknesses of the simple capital assets ratio just described, U. S. bank regulators formally agreed with other member countries of the bank for international settlements to implement two are risk based capital ratios for all commercial banks under their jurisdiction. The BIS phased in and fully implemented these risk-based capital ratios on January 1, 1993, under what has become to be known as the Basle (or Basle Agreement).

Regulators currently enforce the Basel agreement along side the traditional leverage ratio. To be adequately capitalized a bank has to hold a minimum total to risk-adjusted assets ratio of 8 percent that is:

$\text{Total risk-based Capital Ratio} = \text{Total capital (Tier 1 plus Tier 2)} / \text{Risk adjusted assets} > 8\%$

In addition, the tier 1 core capital component of total capital has its own minimum guideline:

$\text{Tier 1(core) capital Ratio} = \text{Core Capital (tier 1)} / \text{Risk adjusted assets} > 4\%$

That is, of 8 percent total risk-based capital ratio, a minimum of 4 percentages has to be held in core or primary capital.

Capital: A bank's capital is divided into Tier 1 and Tier 2. Tier 1 capital is primary or core capital and must be minimum of 4 percentage of a bank's risk-adjusted assets while Tier 2, or supplementary capital is the make-weight such that:

$\text{Tier 1 capital} + \text{Tier 2 capital} > 8\% \text{ of risk-adjusted Assets}$

Tier 1 Capital: Tier 1 capital is closely linked to bank's book value of equity reflecting the concept of the core capital contribution of a bank's owners. It includes the value of common equity, plus an amount of perpetual preferred stock, plus minority equity interest's held by the bank in subsidiaries, minus goodwill. Goodwill is an accounting item that reflects the excess a bank pays over market value in purchasing or acquiring other banks or subsidiaries.

Tier 2 Capitals: Tier 2 capitals are broad array of secondary capital resources. Tier 2 includes bank's loan loss reserves up to a maximum of 1.25 percent of risk-adjusted assets plus various convertibles and subordinated debt instruments with maximum caps.

Risk Adjusted Assets: Risk-adjusted assets are the denominator of risk-based capital ratios. Two components comprise risk-adjusted assets:

Risk-adjusted Assets = Risk-adjusted on Balance-sheet assets + Risk-adjusted off balance-sheet assets.

Capital Adequacy Norms: Risks of Urban co-op banks: Urban cooperative banks are in the news and for wrong reasons. From the mashavpura collapse, the ills of the UCBs are being brought home to people. But on what framework so they work? The capital adequacy norms suggested by the Basle committee have been accepted and adopted by the Reserve Bank of India.

It has come up with a uniform methodology of computing the capital adequacy ratio (CAR) of banks and the same is applicable to all urban co-operative banks from March 31.

Banks failing to maintain 75 percent of the required CAR will be classified as weak and those failing to maintain 50 percent of the

required ratio would be classified as sick. The weights have not been appreciated by a majority of urban co-operative banks because in assigning the weights, there is a large number of the banks being pushed into the weak category.

In terms of guidelines provided, the balance kept with the RBI alone will carry zero weight whereas the deposits kept with other banks including nationalized banks will carry a risk weight of 20. The risk weight assigned to government securities is only 2.5. However, the government borrowings under government securities have a risk weight of 2.5. The nationalized banks are wholly owned by the centre but the risk weight assigned is 20.

Capital Adequacy in BSE and NSE: At BSE, there is an anomaly in capital adequacy norms. NSE requires up front capital from brokers of 12% and BSE requires upfront capital of 5%. This state of affairs-where BSE uses much weaker capital adequacy norms than NSE has persisted for years. This state of affairs is as unsatisfactory as one where RBI might ask certain bank to have a 9% capital adequacy norm but allow others to get away with 3.75%. A bank, which used 3.75% capital adequacy, would be fragile indeed and it is no surprise that BSE is fragile. Matters are worsened when we consider that margin enforcement at BSE is reputed to be quite spotty.

7.6 GUIDELINES OF RBI FOR CAPITAL ADEQUACY

The recent Asian crisis has underlined the critical importance of undertaking reforms to strengthen the banking sector. In recent years, RBI has been prescribing prudential norms for banks broadly consistent with international practice. To meet the minimum capital adequacy norms set by RBI and to enable the banks to expand their operations, public sector banks will need more capital with the government budget

under severe strain, such capital has to be raised from the public which will result in reduction in Government shareholding. To facilitate this process, Government have decided to accept the recommendations of the Norseman committee on Banking Sector Reforms for reducing the requirement of minimum shareholding by government in nationalized banks to 33%. This will be done without changing the public sector character of banks and while ensuring the fresh issue of shares have sufficient autonomy to take decisions on corporate strategy and all aspects of business management and be responsible to the stakeholders, that is the shareholders the customers the employees of the nationalized banks will be fully safeguarded. It is proposed to bring about necessary changes in the legislative provisions to accord necessary flexibility and autonomy to the boards of the banks.

Capital Adequacy for Subsidiaries: The Basel Committee on Banking Supervision has proposed that the new capital adequacy framework should be extended to include, on a consolidated basis, holding companies that are parents of banking groups. On prudential considerations, it is necessary to adopt best practices in line with international standards while duly reflecting local conditions.

Accordingly, banks may voluntarily build-in the risk weighed components of their subsidiaries into their own balance sheet on national basis; at par with risk weights applicable to the banks own assets. Banks should earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switchover to unified balance sheet for the group as a whole is adopted after sometime. The additional capital required may be provided in the bank's book in phases, beginning from the year-ended March 2001.

A consolidated bank defined as a group of entities which include a licensed bank should maintain a minimum capital to Risk-weighted assets ratios (CRAR) as applicable to the parent bank on an on going basis from the year ended 31 March 2003. While computing capital funds, parent bank may consider the following points: -

Banks are required to maintain a minimum capital to risk weighted assets ratio of 9%. Non-bank subsidiaries are required to maintain the capital adequacy ratio prescribed by their regulators.

Risks inherent in deconsolidated entities in the group need to be assessed and any shortfall in their regulatory capital in the deconsolidated entities should be deducted from the consolidated bank's capital in the proportion to its equity stake in the entity.

7.7 MEASURES TO IMPROVE CAPITAL ADEQUACY

As there is a growing pressure on the banks to strengthen their capital positions and maintain adequate capital, the need to raise and manage capital is gaining importance. Generally, there are four important measures, which a bank can undertake to raise its capital base and improve its capital adequacy ratio. They are:

- Augmenting capital through equity and/or debt route
- Augmenting capital through government/budgetary support
- Retaining earnings or profits, and
- Improving asset quality

A bank can augment its capital through issue of shares, raising subordinated debt and, sale of assets. The choice of any particular source depends on the impact it would have on the returns to shareholders, banks risk exposures, market conditions and regulations. The issue of shares is an expensive method of raising capital. Only profit

making banks can approach the capital market and the dividends should be attractive enough to woo the investors. Moreover, new stocks dilute the control of the existing stakeholders at the same time the gearing or leveraging capacity of the bank increases. The raising of subordinated debt is cheaper and the interest payment is tax deductible.

In the early 1990s the Government of India was providing budgetary support to Public Sector Banks by improving their capital base. It has also been using the World Bank Aid for financial sector reforms to improve the financial health of the banks. Such supports are not available to banks on a long-term basis and have since been stopped/restricted, as it is a burden on the public exchequer.

One of the major sources of capital is the retained earnings or profits. By internally generating capital the banks do not depend on the open market for funds and thus avoid the costs of floatation. It does not threaten the existing stockholders in that their ownership is not diluted nor is the earnings. However, the internal capital is significantly affected by movements in interest rates and economic conditions, which are beyond the control of the bank management but influence its earnings.

The retained earnings depend on the dividend policy of the banks. The banks have to decide on an optimal dividend policy to maximise shareholders value (matching the retention ratio i.e. the ratio of current retained earnings divided by current after tax net income and the dividend payout ratio i.e. current dividends to stockholders divided by current after tax net income). This will attract new shareholders and the existing shareholders are retained in that the return on owners' capital at least equals the returns generated on comparable investments with similar risks. A key element in deciding on an optimal dividend policy is the rate of growth in assets so that its existing ratio of capital to assets is protected from erosion. In other words, the internal capital growth rate

(ICGR) is the multiplier of ROE and Retained Ratio. To illustrate the point, let us assume that a bank has planned an ROE of 15% for the year and intends to pay a dividend of 40% of the net earnings. The ICGR will be $ROE \times \text{Retention Ratio}$ i.e. $0.15 \times 0.60 = 9$ per cent. This indicates that the rate of growth of capital for the bank is 9%. In case it falls below it, the regulators may insist on increase in capital. The banks have to maintain asset equality and plan for booking assets/contingent exposures which carry less risk weights. Non-performing assets impair capital and only through good quality assets can banks generate profits and improve capital position.

7.8 NON PERFORMING ASSETS (NPA) IN BANKS

The Indian financial sector has undergone significant transformation during the ten years of financial liberalisation. Banking sector reforms, introduced over a decade ago in 1992-93, have been based on five fundamentals: strengthening of prudential norms and market discipline, appropriate adoption of international benchmarks, management of organisational change and consolidation, technological upgradation, and human resource development. A hallmark of the entire financial sector reform process has been the element of 'gradualism', with the consideration of the timing, pacing and sequencing, following extensive consultations with the stakeholders at each stage.

It is widely recognised that because of these reforms, the Indian banking system is becoming increasingly mature in terms of the transformation of business processes and the appetite for risk management. Deregulation, technological upgradation and increased market integration have been the key factors driving change in the financial sector.

The principal challenge of banking soundness emanates from the persistence of the significant amount of non-performing assets (NPAs) on bank balance sheets. A mix of upgradation, recoveries and write-offs has steadily reduced gross NPAs of scheduled commercial banks to 7.5 per cent as at end-March 2005 from 15.7 per cent per cent as at end-March 1997.

A major factor contributing to the high level of NPAs in India has been the inadequate legal framework for collecting overdue loans. Although loans are largely collateralised, in practice, the value of the collateral may not be commensurate with the loans. More importantly, timely execution of collateral often remains difficult. The large difference between banks' gross and net NPAs, typically equal to nearly one-half of gross NPAs, reflects both obligatory provisions against NPAs and the limited write-offs of NPAs by the public sector banks. As a consequence, NPAs tend to be carried on the books and provisions against them gradually built up. In this context, in line with the announcement in the Union Budget 2002-03, Asset Reconstruction Companies (ARCs) have been established with the participation of public and private sector banks, financial institutions and multilateral agencies. Such a move is expected not only to add an extra avenue to banks to tackle their NPAs, but also to provide them with an opportunity to take the NPAs out of their balance sheets. At the same time, it is expected that the ARCs would be able to recover more bad loans (perhaps at a faster pace) because they would be exclusively dedicated towards loan recovery.

The passage of the SARFAESI Act in 2002 has increased the scope for the recovery of NPAs. The Act envisages relatively stricter legislations to provide comfort to banks in taking possession of the securities. Public sector banks have identified (as per latest estimates) NPAs worth over Rs.

12,000 crore to be sold to the ARCs; however, the process of valuation of the loans prior to sale is yet to be completed.

The Reserve Bank has recently issued guidelines on preventing slippage of NPA accounts. Under this process, banks have been advised to introduce a new asset category: 'special mention accounts', in between 'standard' and 'sub-standard' categories for their internal monitoring and follow up. This is expected to enable banks to look at accounts with potential problems in a focussed manner right from the onset of the problem so as to impart efficacy to monitoring and remedial actions.

The level of Non-Performing Assets (NPAs) of the banking system in India has shown an improvement in recent years, but it is still too high. Part of the problem in resolving this issue is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful. The Narasimham Committee and the Verma Committee (which recently submitted its report) have looked into the problems of weak banks and have made certain recommendations which are under consideration of Government and the Reserve Bank. These are also being widely debated, so that an acceptable long-term solution can be evolved. Leaving aside the problem of weak banks, in profitable banks also, the NPA levels are still high. A vigorous effort has to be made by these banks to strengthen their internal control and risk management systems, and to set up early warning signals for timely detection and action. The resolution of the NPA problem also requires greater accountability on the part of corporates, greater disclosures in the case of defaults, and an efficient credit information system. Action has been initiated in all these areas,

and it is hoped that, with the help of stricter accounting and prudential standards, the problem of NPAs in future will be effectively contained.

The problem of NPAs is also tied up with the issue of legal reform. This is an area which requires urgent consideration as the present system, involving substantial delays in arriving at a legal solution of disputes, is simply not tenable. It is hoped that recent efforts, such as establishing more Debt Recovery Tribunals and setting up of Settlement Advisory Committees in banks, would help. However, there is an urgent need to institute a proper legal framework to ensure expeditious recovery of debt and give adequate legal powers to banks to effect property transfers. The absence of quick and efficient system of legal redress constitutes an important 'moral hazard' in the financial sector as it encourages imprudent borrowing.

7.9 SUMMARY

Capital Adequacy provides protection to depositors and other creditors in the event their assets decline in value or the financial institution suffer losses. There are several definitions of capital depending on the regulatory agency involved. Some of these measures include loan loss reserves, redeemable preferred stock and certain qualified debt instruments. Capital Adequacy relates to the firm's overall use of financial leverage. It also measures the relationship between firm's market value of assets and liabilities and the corresponding book value. Not all source of capital show up on the firm's balance sheet.

Ratio approaches are among the oldest methods of capital adequacy analysis and are still widely used by both managers and regulators. A traditional approach to developing ratio standards is to use judgement to set a level of capital that is believed to provide a reasonable cushion in light of experience. Judgement may be supplemented by

studies of past failures. When regulators are developing ratio standards, they are more interested in the solvency of banking system than in single financial institutions. Risk based capital asset is another approach to capital adequacy measurement. Proposals for risk-based capital standards have been around for years and are getting increased attention. Under the proposal being developed, off balance sheet claims such as credit guarantees would be given a weight and added to actual assets. The appeal of the risk-based approach is that it is a step forward from simply looking at total assets in terms of riskiness. The risk-based approach also has the advantage of requiring capital to support off balance sheet source of risk such as loan guarantees.

The principal challenge of banking soundness emanates from the persistence of the significant amount of non-performing assets (NPAs) on bank balance sheets. A mix of upgradation, recoveries and write-offs has steadily reduced gross NPAs of scheduled commercial banks to 7.5 per cent as at end-March 2005 from 15.7 per cent per cent as at end-March 1997.

A major factor contributing to the high level of NPAs in India has been the inadequate legal framework for collecting overdue loans. Although loans are largely collateralised, in practice, the value of the collateral may not be commensurate with the loans. More importantly, timely execution of collateral often remains difficult. The large difference between banks' gross and net NPAs, typically equal to nearly one-half of gross NPAs, reflects both obligatory provisions against NPAs and the limited write-offs of NPAs by the public sector banks.

7.10 KEYWORDS

Bank capital: Bank capital refers to the funds contributed by the shareholders or owners consisting of common stocks, reserves and retained earnings. It is also called the net worth of a bank.

Common stock: It represents the par value of common equity shares contributed by shareholders.

Reserves & Surplus: It constitutes undistributed profits and other inflows earmarked for specific purposes like cash reserve as stipulated by Reserve Bank of India.

Balance in Profit & Loss account: It is the part of the retained earnings that remains in the business after transfer to reserves.

Loan Loss reserves: It is the reserve created out of the total earnings before arriving at net profit and earmarked against possible loan losses.

Capital to risk weighted assets: A bank is required to hold adequate capital commensurate with the risk profile of its assets. A bank should hold a minimum amount of *capital to risk weighted assets*, called the Capital to Risk-weighted Assets Ratio (CRAR). The CRAR is calculated as under:

$$\text{CRAR} = \frac{\text{Capital}}{\text{Risk weighted assets}} \times 100$$

7.11 SELF ASSESSMENT QUESTIONS

1. Discuss the concept of capital adequacy. What is the present position of capital adequacy in Indian banks both private and public sectors?

2. Discuss capital planning. How capital planning is different from capital adequacy? What are different approaches of capital adequacies?
3. Write short notes on: (i) RBI Guidelines on Capital Adequacy, (ii) Capital Assets Ratio.

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4.0 Objectives

After reading this lesson, you should be able to-

Understand how the banks ensure safety of the funds advanced by them; Know about the legal provisions regarding the modes of creating charge over the tangible assets; Describe the rights and duties of a banker as a pledgee, unpaid seller and mortgagee.

Summary

A sound banking is based on safety of funds lent by a banker to his customer. The first and the most important criterion to judge safety of funds is the capacity of the borrower himself to repay the amount of loan. Secured advances provide absolute safety to the banker by means of a charge created on the tangible assets of the borrower in favour of the banker. The modes of creating charge include lien, pledge, hypothecation and mortgage.

The right of general lien empowers the banker to retain all securities of the customer in respect of the general balance due from him. The banker is, however, not entitled to realise his from the said assets of the customer. Under pledge, the banker as a pledgee has the right to retain the goods pledged for the payment of the debt or the performance of the promise. The pledgee can also claim any extraordinary expenses incurred by him for the preservation of the security. The pledgee has the duty to return the goods on payment of debt and is also responsible to the pledger for any loss of goods, if the goods are not returned by him at the proper time.

Hypothecation, which is another method of creating a charge over the moveable assets, neither transfer ownership nor possession of good to the creditor but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker,

whenever the latter requires him to do so. Another mode of creating charge is mortgage. The right of a banker as mortgagee is to obtain from the court a decree that the mortgager (borrower) shall be absolutely debarred of his right to redeem the property or a decree that the property be sold.

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Keywords

CRR: The cash which banks have to maintain with the RBI as a certain percentage of their demand and time liabilities.

Bailment: Section 148 defines bailment as the “delivery of goods from one person to another for some purpose upon the contract that the goods be returned back when the purpose is accomplished or otherwise disposed of according to the instructions of the bailor”.

Pledge: According to section 172 of the Indian Contract Act, 1872 pledge is defined as “bailment of goods as security for payment of a debt or performance of a promise”.

Hypothecation: Hypothecation is another method of creating a charge over the movable assets. Under hypothecation neither ownership nor possession of goods is transferred to the creditor but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so.

Mortgage: Section 58 of the Transfer of Property Act 1882 defines mortgage as “the transfer of an interest in specific immovable property for the purpose of securing the payment of money, advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”.

Ch-5

5.1 Introduction

Lending is the main function of banking and banks can fail if their loans are bad. Moreover, banks can lose profits if they do not seize opportunities for good lending. Security protects the lender in case things go wrong. The assets commonly charged as security are mainly land (including buildings), stocks and shares, and life assurance policies. In law these are all 'choses in action', assets evidenced by documents (certificates, deeds etc.). Banks much prefer dealing with securities where ownership can be evidenced in this way rather than with chattels such as cars, plants and machinery or furniture. However, valuable this may be, it cannot be charged or controlled as effectively as land, shares or life policies. This lesson would cover general principles of secured advances, classification of advances against goods, advances against documents of title to the goods and advances against stock exchange securities.

Summary

A banker should observe some basic principles while granting advances against securities offered by customers. These principles are: adequacy of margin, marketability of securities, documentation, and realisation of the advance if the borrower defaults. The advances are generally sanctioned, by the scheduled banks in India, against the security of goods, documents of title to goods, stock exchange securities, life insurance policies, real estate, fixed deposit receipts book debts, and gold ornaments and jewellery.

Goods and commodities as security to the banker offer the advantages of better security, stable prices of necessary goods and easy liquidation. However, a banker should be careful about- (a) whether the goods are adequate security; (b) nature of demand of the goods; (c) valuation of goods; (d) insurance of goods, (d) delivery time and storage

facility. The advances against documents of title to goods are subject to some risks, for instance, false description of the goods in the documents of title which are pledged with the banker. The risks in advancing against shares include liability in case of partly paid up shares, company's right of lien on shares, and risks of forgery of share scrips. Thus, almost every kind of security accepted for advances possess some risk. So the banker must be extra-ordinary careful while lending against these securities.

Keywords

Documents of title to goods: A document of title to goods is a document used in the ordinary course of business as a proof of the possession or control of goods. Bill of Lading, Dock Warrants, Warehouse-keeper's or wharfinger's certificate, railway receipts and delivery orders are the instances of the documents of title to goods.

Bill of lading: A bill of lading is a document issued by a shipping company acknowledging the receipt of goods for carrying to a specified port. It also contains the conditions for such transportation of goods and full description of the goods, i.e., their markings and contents as declared by the consignor.

Railway receipt: Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is transferable but not a negotiable instrument. It can be transferred by endorsement and delivery.

Stock exchange securities: The term stock exchange securities refers to those securities which are dealt with on the stock exchange.

Trust receipts: The goods or the documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes the

borrower wishes to get the security released before he actually repays the loan. In such cases, the banker may, at his discretion, allow the customer to get back the goods or documents and ask the latter to execute a Trust Receipt.

Security: 264

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Ch 6

Summary

The contracts of guarantee have special significance in the business of banking as a means to ensure safety of funds lent to the customers. An additional security (i.e. in addition to a charge over the

tangible assets owned by the borrower) is sought by the banker in the form of a 'guarantee' given by a third party. This third person must command the confidence of the banker. In a contract of indemnity, the person who promises to make good the loss is called the 'indemnifier' and the person whose loss is to be made good is called the 'indemnified'. Further, a person may undertake to save the other from loss caused to him, by the conduct of a third person either at the request of the third person or without any request from such third person. In the first case there would be a 'contract of guarantee' and in the latter case there would be a contract of indemnity and the third person (debtor) cannot be held responsible to the indemnifier as there is 'no privity of contract' between them. Indemnity holder is entitled to recover all damages which the promise to indemnity applies.

Keywords

Contracts of guarantee: A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person in case of his default" (Sec. 126 of Indian Contract Act, 1872).

Contract of indemnity: A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a contract of indemnity (Section 124 of Indian Contract Act, 1872).

Continuing guarantee: A guarantee which extends to a series of promises or transactions is called a 'continuing guarantee' (Section 129 of Indian Contract Act, 1872).

Surety: The person who gives the guarantee is called the 'surety'; the person in respect of whose default the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'.

Co-surety: When more than one person guarantee a debt, all of them are called co-sureties and are liable to pay the debt of the principal debtor.

Ch 7

7.0 Objectives

After reading this lesson, you should be able to-

Define bank capital; Explain the various components of capital; Explain the methodology to determine capital adequacy; Explain the regulatory guidelines on capital adequacy; and Understand NPA problem in Indian Banks.

7.1 Introduction

Capital is essential and critical to the perpetual continuity of a bank as a going concern. A minimum amount of capital is required to ensure safety and soundness

Summary

171, 172, 173, 180

Keywords

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Reserve and Surplus:

Loan loss reserve:

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