SUGGESTED ANSWERS

PROFESSIONAL PROGRAMME EXAMINATION (NEW SYLLABUS)

ELECTIVE PAPER 9.1 – BANKING LAW AND PRACTICE

PRACTICE TEST PAPER

OPEN BOOK EXAMINATION

Time Allowed: 3 Hours Maximum Marks: 100

Attempt all questions. All questions are compulsory.

Question No. 1

Read the case study and answer all questions given at the end of the case:

ABC ALUMINIUM COMPANY PVT. LTD.

This case relates to m/s ABC Aluminium Company Pvt. Ltd, a SSI unit located at Delhi Rohatak road, Haryana. The unit is in an area where cluster of industries have come up. It is located in an industrial area where all the infrastructure facilities are available.

The total capacity of the plant was 10 TPD which comes to 3000MT per annum. The company was provided medium term loan (MTL) of Rs 150.00 lacs and a cash credit (working capital) advance of Rs 160.00 lac. The loan was sanctioned by a nationalized bank at Patna and a sub limit was provided from one of the branches located at New Delhi for better control and supervision of account.

The promoters (directors) were from Patna (Bihar). They had a wooden ply industry at Patna, where they earned good money. Later on, during 1996 the pollution control board-department of government did not permit falling of the trees and transporting of local wooden logs and owner of the ply unit who promoted ABC Aluminium Company Pvt. Ltd deserted Patna and shifted to Rohtak for setting up this aluminium based plant.

Since the directors had contact with the bank at Patna during their plywood business at Patna they had a good and long relationship with the bank at Patna. The promoters approached the nationalized bank at Patna for creating the ABC Aluminium Company Pvt. Ltd for financial assistance. The bank asks for certain important information to satisfy them before appraisal of the loan proposal. The information asked was:

- Application form dully filled in.
- Memorandum and Article of Association of the Company.
- Allotment of land by Haryana Government- Industrial Area Development Authority.
- Project Report.
- Details of layout- land, building and detailed drawings of;
  - Administrative building
  - Factory shed
  - Go downs
  - Other civil constructions
- Quotations of machinery
- Estimate of civil construction duly signed by a civil engineer.
- Details of collateral securities of directors- land and building offered.

- Details of land and building of the plant allotted by Government at Rohtak.
- Means of financial strength of promoters and total source of capital to be raised.

The bank appraised and sanctioned the loan. The raw material is locally available and import of scrap material is permitted at lower excise duty and found to be competitive.

The project performance was critically examined by the bank before sanction of the loan. The parameters covered were:

- Capacity of the project to perform.
- Projected level of working.
- The Break Even Point
- Sales at projected level
- Elements of cost of production

Based on the true value of expenses the projected performance at the time of sanction of loan was as under:

Projected level of working 50%			
Sales quantity = 1500 MT(Metric Tonnes) at 50% capacity			
Sales Price (average)= Rs 105,000 per MT			
	100% Level	50% Level	**(Rs in lacs)**
Yearly Sales	3150	1575	**A**
Variable Cost			
Cost of Raw Material	2677	1340	
Fuel for Furnace	112	56	
Fuel for DG set	52	26	
Other Fuel	26	13	
Cost of Tools & Dies	8	4	
Wages	15	10	
Sub Total	**2896**	**1453**	**B**
Contribution (A-B)	**254**	**122**	**C**
Fixed Cost			
Salary	6	6	
Selling General and administrative expenses	24	24	
Interest on Working Capital	48	24	
Interest on Term Loan	18	18	
Depreciation	12	12	
Total Fixed Cost	**108**	**84**	**D**
PBT (C-D)	146	38	
Depreciation	12	12	
Cash Accrual	158	50	
Break Even Sales	1339.37	1084.42	
Break Even %	42.51	68.85% of Operation	

Based on the performance the term loan against fixed assets amounting to Rs 150 lacs was Sanctioned to be repaid in seven years and was termed as medium term loan (MTL). Also using the Tandon committee norms a working capital of Rs 160 lacs was sanctioned.

After the sanctioned was made following securities were obtained:

- Hypothecation of stocks
- Pledge of land, buildings, plant and machinery and other assets of the company.
- Equitable mortgage of director's property (land and building) offered as collateral security.
- Liens on the shares hold by directors.
- A lien on NSC and PPF.
- Creating charge of assets of the company with Registrar of the Company, being a private limited company.

Later on during the year 2002 the company's performance declined which was a threat and an early warning signal for the bank and for the company. The symptoms noticed by the bank were:

- Sales proceeds were not fully rooted through bank account.
- The drawing power declined and account became irregular.
- The term loan installments became overdue due to non-payment in time.
- The account was feared to be NPA.

The matter was reported to the head office of the bank and a detailed study was conducted by a team of experts the details of diagnostic study and its recommendations follows.

Technical feasibility and problem faced by the company were conducted, the details of which are:

Process of manufacturing
It was found to be a successful process and was accepted by the bank.

Capacity of the plant
The machines were found in sound state of operation and the capacity was arrived at 3000 MT per annum while working on three shifts.

During the study to minimise losses and improve the quality of product following recommendations were made:

- The scrap should be shorted out based on their quality.
- Small and lighter scraps should be bundled on bundling machines to give it a compact look. For each charge an input output record needs to be maintained to measure operational losses.
- The quality of raw material should be chemically examined before charging in to the furnace. For this a simple material testing equipment is needed. The charge to the furnace needs to be standardized.
- At furnace point there should be a temperature measuring device to exactly note the temperature.

Land and building
It was observed that land and building is adequate to accommodate the present facilities needed for production and there is a room for 100% expansion.

Teething problems faced

At the time of financing the proposal there was no room for tools and dies which is a large component of investment. The company created a die-shop by diverting funds without informing the bank. It was a necessary component of the project cost which was not taken in to account while sanctioning the project. The cost of die-shop and dies was about Rs 20lacs and this resulted in to short fall in working capital fund due to diversion in this case short term source was used for long term uses causing a setback in the current asset value. The project was found technically feasible and was in a perfect working order.

Economic viability

Following data were analysed and based on these current data the economic feasibility was determined:

- Work force strength planning and its cost.
- Cost of raw material- a material-mix was arrived at. The weighted average material cost was arrived at Rs 89,250 per MT including 5% losses during the process.

Revised working capital was assessed and the components of working capital were as under:

Raw materials	23 days
Stock in process	7 days
Finished goods	9 days
Receivables	26 days
Total working capital cycle	60 days

It was seen that the present working capital limit was adequate but there was a gap between the current asset needed and current asset available. Which needs to be bridged by the company?

The company was found to be economically viable and capable to serve its interest and instalments for medium term loan already granted to it.

What went wrong?

- The company did not record its sales fully and due to unrecorded sales it resulted in to wrong performance than actual.
- The company also followed the practice of under billing.
- Sells to some small petty traders were not recorded at all and such traders were twenty two in numbers.
- Company diverted about Rs 25 lacs in creating a tool room and dies which resulted in to diversion of fund within the industry (diversion from short term sources to long term uses).
- The company opened an account in different bank and routed the sales and deposit through current account which was not proper.
- There was exemption of sales tax (VAT) which the company did not avail fully which was due to their inclination towards cash dealing without billing.
- The bank-customer relation was affected badly leading to strain relationship.
- Stock statements were not submitted in time and bank operation turned poorer day by day.

- The directors have created good asset in the form of self-owned building at Rohtak out of fund generated but diverted. Here this case was an example of healthy entrepreneur and sick industry.

The diversion of fund was traced and this amounted to about Rs 190 lacs during the past four years of operations which were as under:

Under billing	Rs 150 lacs
Dies and tool room	Rs 25 lacs
Construction of house	Rs 50 lacs
Total	**Rs 190 lacs**

This resulted into short fall in working capital and instalments payments to the bank resulting in to this bad shape.

Past four years of operation is an indicator of manipulation of facts which is detailed here under:

Year wise cash Accrual (Rs in lacs)

Year	Profit/Loss	Depreciation	Cash Accrual	Sales
1998-99	(-1.51)	10.77	9.26	241.90
1999-2000	(-2.20)	10.64	8.44	175.45
2000-2001	0.36	11.00	11.36	324.86
2001-2002	(-13.8)	11.25	(-2.55)	240.01
Total Cash accrual			26.51	

The sales do not correlate with profit or cash accrual and the diversion of fund is feared.

The increase in depreciation shows that there is a creation of fixed asset by diversion of fund.

The fixed assets added were as under:

Period wise addition of fixed assets

Year	(Rs in lacs)
1998-99	23.17
1999-00	10.49
2000-01	11.15
2001-02	06.50
Total	51.31

Decision by the bank to take up the rehabilitation/ restructuring

The account in the books of the bank has turned sticky and irregular and is classified as NPA but it has strength for rehabilitation and restructuring since the major diversion were within the business. It may be considered for rehabilitation and restructuring. Following were the terms and conditions of the bank for taking up this case for rehabilitation:

- Closing the account of another bank- CBI Paharganj, New Delhi as banking with other bank is not allowed mainly which is not lender to the company.
- Providing additional working capital mainly coverage of Sundry Dr by clean bill limit.
- Restructuring the term loan and its repayment plan.
- Since it was a willful default, no concession in interest should be permitted.

- The company should route the sales proceeds through bank account only and avail the bill limit by drawing bills through bank.
- The company must start working at least at 40% capacity utilization which is higher than BEP and try to increase its level of operation subsequently.
- Additional security should be provided in the following manner.
    - Pledge or mortgage of additional fixed assets created by diversion of fund.
    - Equitable mortgage of land and building of directors created in personal or family name.
    - Hypothecation of current assets covered under working capital and its renewal from time to time.
    - Bringing fund in proportion to margin (own contribution) as required by the bank by raising the paid up capital.

Considering the facts and reasonable opportunity and probability to put the company on a proper track it is possible to rehabilitate the company by adopting honest practices and by creating a smooth bank-customer relationship. The care the bank should take is a stricter follow up, monitoring and control.

This decision will bring the company as a successful venture and will turn it in to a growing concern. This decision will add to the following advantages:

- The assets which may turn idle or scrap will be utilized.
- It will create better employment opportunity for the youth.
- The banks money will be realized and its NPA will be reduced. Also the bank will gain in long term in the form of interest earning which will keep on growing in relation to the growth of the company.
- The company directors and shareholders will be satisfied persons.
- By growth the company will expand providing more services to the nation.

Questions: (related to case study) **(5 marks each)**

Q1 (a) What have you learnt from this case?

Ans: The following are the major learnings from this case:

i. The capacity of the plant was 10 TPD (Tones per day) but the capacity utilization of the company was very low which was at 20% that was below the Break Even Point.

ii. The promoters of the company had experience in ply-wood industry and this project was not in line with their experience. They did not have knowledge of aluminum business mainly related to manufacturing by extrusion of aluminum which was highly technical in nature. This resulted into losses.

iii. The documents to be presented to the bank for sanction of the loan includes- Application form, Memorandum and Article of Association of the company, Land Allotment Order, Project Report, Details of Drawings and civil construction with Estimates of cost, Quotations of machineries, Details about directors etc.

iv. It highlights the contents of the projected performance and it could be seen that 50% level of operation is adequate at which the project is economically viable.
v. The case also explains the calculation of BEP (Break Even sales) based on the projected performance.
vi. The major security documents to be obtained by the bank were hypothecation of stocks, pledge of land and buildings, Lien on the shares held by the directors, lien on the NSCs and PPF of directors and creation of charges on the assets of the company with Registrar of the companies. These security documents safe guard the interest of the bank legally.
vii. There are stages of declining performances of the company.
viii. Company's mismanagement of fund leading to losses was also experienced.
ix. The case also provides a lesson to learn about diversion of current assets in to fixed asset for creating plant and machinery without permission of the bank, causing shortfall in the Working capital.

The case also explains how a sick industry could be rehabilitated (brought back to health) with control and proper management.

Q1 b) Why did the industry faced this problem?

Ans: The problems faced by the industry were due to following factors:

i. The promoters did not have the experience or background of the activity and they switched over from wood business to metal business that caused teething problem for them.
ii. Major sales proceeds were not routed through bank account (working capital/cash credit account) that was against the law of banking.
iii. The account turned sticky and NPA (Non-Performing Asset).
iv. They did not maintain proper quality of the products due to poor material-mix and there was no testing lab.
v. They never measured the input-output relationship that resulted into losses during the process. It was a thumb-rule of management.
vi. There was no check on the quality of raw material causing poor product quality.
vii. The temperature of the furnace was never controlled in a scientific way resulting into loss of material during the process. This also affected the quality of the product.
viii. At the time of sanction of the loan the cost of tools and dies were not taken into account for arriving at total cost of the project and bank loan was not provided against this head. Further, the promoter (borrower) diverted the short-term loan in to long term uses causing depletion in working capital.
ix. Under billing and un-recorded sales of goods were the major causes of sickness.

x. Opening of parallel current account in a non-lender bank was beyond banking law and that too without lender-bank's permission which diluted the faith resulting into poor relationship between the company and SBI.

Q1 c) Is it the case of NPA or sickness?

Ans: This account of ABC aluminium Private Ltd. has turned both NPA and Sick and that is clear from the following facts:

It is NPA because the account turned irregular and sticky. Also the unit was not routing its sales proceeds through bank i.e. their working capital (Cash credit) accounts. The unit was not able to serve interest and installments of term-loan. The company turned dishonest and opened a parallel current-account with another nationalized bank and started functioning and routing its sales proceeds through this account.

It has turned sick also as it was not able to generate adequate fund (Profit/cash accrual) to meet its interest and installments. Also the account was irregular and more than 50% capital was eroded which is a condition of sickness as per guide-lines of RBI.

Also there was a continuous loss causing erosion of equity and depletion in the working capital of the company that is clear from the following data of the past performance.

(Rs in lacs)

Year	1998-99	99-2000	2000-2001	2001-02
Loss/Profit	(-I.51)	(-2.2)	+ 0.36	(-13.80)

The accumulated loss comes to Rs 17.15

Q1 d) How did the bank tackle the case?

Ans: A detailed techno-economic study was conducted and following facts were obtained:

a) The process was suitable and successful.
b) Plant and machines were found in order.
c) Major diversion of fund was within the business but short term sources were utilized for long term uses.
d) Methods to improve the quality of the product and process were realized.
e) The quality improvement process was suggested.
f) Following technical improvements were planned :

i) Measuring input-output to know the process losses.

ii) Scrap, the main input should be selected and segregated based on their type and quality.

iii) The raw material quality to be chemically tested.

iv) Charging of furnace to be standardized and a temperature measuring device to be installed to avoid over heating losses.

g) The projected performance was drawn and based on working capital cycle the working capital requirement was worked out, based on Tandon Committee norms.

h) It was arrived that the project is technically feasible and economically viable.

i) Tighter control and monitoring made necessary.

j) Further, following steps were taken by the bank to rehabilitate the company:

   i) Closing of other bank (CBI) account.

   ii) Providing fresh working capital.

   iii) Re-structuring the loan accounts.

   iv) As it is a case of will-full default no relief in interest to be allowed.

   v) The industry must rout the sales proceeds through bank account only.

   vi) The directors to provide additional security.

Q1 e) What were wrong practices the company adopted?

Ans: Following were the major wrong practices the company adopted:

a) Materials were not properly stored.
b) Input-output measurements were not recorded.
c) There was no control of temperature of the furnace.
d) Practice of under billing was adopted.
e) Some of the sales were made, un-recorded.
f) Funds were diverted for tools and dies and some machines without informing the bank.
g) Opened a parallel account in another bank which was unethical.
h) Sales proceeds not routed through SBI's account which was the lending bank.
i) There was no system of quality or quality inspection.
j) Diverted fund.
k) Did not adhere to standard banking practices.
l) Sales of 22 buyers were not recorded.
m) Diversion of Rs 25 lacs in creating tool-room without informing the bank.
n) There was exemption in VAT which the company did not avail fully.

o) Stock statement not submitted.

Q1 f) What corrective measures do you suggest?

Ans: Following corrective measures are suggested:

i. To maintain quality of raw materials.
ii. To maintain quality of finished goods.
iii. To maintain input-output records.
iv. Install a temperature measuring device for the furnace.
v. Stocking system to be improved.
vi. To maintain stock statement and bill records and submit it to bank regularly.
vii. To route the sales proceeds through bank account.
viii. To record all sales and avail VAT exemption benefit.
ix. Reflect actual sales and expenses to arrive at factual profit.
x. Avoid manipulating sales.
xi. To close bank account of other bank.
xii. Be true to the business.

Q1 g) Conduct a SWOT analysis of the case.

Ans: SWOT analysis of the case is as follows.

Strength –Following are the strengths:

i. The company has good capacity to produce.
ii. The plant and machines are adequate and in good working order.
iii. There is good demand for the products.
iv. The process is proven one.
v. Technical feasibility is good.
vi. The economic viability is there.

Weaknesses- Following are the weaknesses:

i. Bank-borrower relationship not congenial.
ii. Again the company did not adhere to standard banking norms.
iii. Misappropriation of account feared.
iv. May again start false billing and non-recording of sales.
v. Quality check is poor.
vi. Capacity utilization is poor.

Opportunity- Following are the opportunities:

i. The company has good capacity to produce.
ii. Probability to enhance capacity is there.
iii. Break even at lower level means higher margin of safety.
iv. VAT exemption available.
v. Proven buyers network.
vi. More products and market can be developed.
vii. There is every chance to enhance the performance and profitability.

Threat-Following are the threats:

i. The bank-borrower relationship toughened.
ii. In future the company may again repeat the unethical practice because old habits do not die totally.
iii. May again try miss-billing.
iv. Window dressing to deceive bank.

Q1 h) Do you agree with the recommendation of the bank?

Ans: Yes, I do agree with the recommendations of the bank. Major recommendation wise reason of my agreements are as detailed below.

S. No	Recommendation of the bank	Reasons of my agreement
A	Closing of account with Central Bank	It is against banking rules to open account Without permission of the lender bank
B	Providing fresh working capital	Since the working capital has eroded the Company cannot operate at full scale, without fresh working capital
C	Restructuring of loan	The loan portfolio has disturbed restructuring is the valid solution.
D	Since it is a case of wilful default, no concession on interest given	Since, the company was involved in some unethical practices like diversion of fund and opening of other bank account it may not be given concession.
E	Sales to be routed through bank account	This will ensure that flow of funds are recorded properly and funds are not diverted thereby assist in reaching at true picture about the company's performance and check any unethical practices on the part of the company
F	Additional Security	Since there was diversion and default , additional Security will be in the interest of bank

Q1 i) For additional security of the loan what documents you should obtain as a Branch Manager?

Ans: It is necessary to obtain documents, legally executed by the borrower (Company) to keep the interest of bank lawfully intact. For this, following documents shall be obtained by a Branch Manager:-

a) Hypothecation of stocks.
b) Pledge of land, building and other fixed assets.
c) Equitable mortgage of Director's property as an added security.
d) A lien on the shares, of directors to have a right to sell in case warranted.
e) A lien on NSCs, PPF, and LIC policies.
f) Creating and registering a charge on assets of the company in the office of the registrar of the companies.
g) Hypothecation of bills routed through bank with a power to recover it directly.

Q1 j) It is very easy to call up the loan ending the bank-customer relationship, but difficult to retain it for a long period. In your opinion what would be advantages to the Company, its shareholders, bank and Nation if it is brought back to good health as a discipline entrepreneur?

Ans: **a) Advantages to the company**: following shall be the major advantages to the company-

i) It will start generating profit.

ii) The idle assets shall be utilized.

iii) It will turn to be a growing concern.

iv) The relationship between bank and company will be better.

v)It will create an identity.

b) Advantages to the bank:

i) The NPA shall be reduced.

ii) The money blocked shall revolve and generate interest to the bank.

iii) Bank's fund shall be utilized well.

iv) Bank's relationship that went strained shall roll back to normal.

v) The total recovery of dues of the bank shall be realized.

vi) It will be a cash cow for the bank. Chance to enhance investment in future

c) Advantages to the Nation:-

i) Employment potential shall be created.

ii) Nation shall get revenue in the form of VAT and tax.

iii) It will add to GDP.

iv) May get foreign exchange if products are exported.

v) Local society and stake holders shall be benefitted.

vi)The idle asset for nation shall be put in use.

Question No. 2 (a)

What are the important documents banks generally obtain for each liability (loan) created? Mention period of each type of documents before it is time barred. As a consultant to the bank what guide lines you should provide to the bank to prevent the document to become time barred?

(10 marks)

Answer:

Following are the nature of securities by which the bank is able to create charges and legal rights.

1. Pledge
2. Hypothecation
3. Mortgage
4. Assignment
5. Lien

For each a detailed discussion follows indicating its use, documents to be taken and time limitations.

Pledge of Securities- Pledge relates to the bailment of goods for providing security against debt/loan obtained from bank (Sec.172 of Indian Contract Act-1872). It is against moving stocks e.g. Gold, materials etc. The documents taken is 'an Agreement of Pledge also termed as deed of- pledge'. It is taken on a non-judicial stamp paper or adhesive stamps. To protect the interest of the bank the agreement in writing should incorporate the exact terms and conditions. For example-when a farmer takes gold loan the gold is pledged and the bank provides loan to the farmer. Time limit of document is 3 years and is renewed before its expiry by obtaining a simple letter of renewal and this provides an extended life to the document.

Hypothecation over Securities- Hypothecation means charge created on any movable asset against a loan borrowed by the owner of the goods (existing or future)

Document taken is “Hypothecation Agreement” and provides an opportunity for possession of the goods and after possession of the goods the charge is treated as pledge and may be disposed to recover the loan. A display on board, indicating goods hypothecated to ----- BANK (Name). The document has to be executed on the legal stamp-paper the duty is based on value and conditions of pledge. The document must bear the full signature of borrower and witness. It must be completed in the bank premises preferably in the chamber of the manager.
In case of a company (Pvt. limited or Ltd) the charge of hypothecation has to be created at ROC from where the company got registration. This exercise is a must.
The time limitation is 3 years and a renewal letter is obtained for extension of the time.
Mortgage- Sec.58-a of the Transfer of Property Act 1882 defines mortgage as under:
A mortgage is the transfer of interest in specific immovable property, for the purpose of securing the payment of money advanced or to be advanced by way of loan on existing and/or future debt which may give rise to a pecuniary liability. The relationship between bank and borrower here is mortgagee and mortgager respectively and these terms are exclusively used while executing the document. In banks usually equitable mortgage where it is just deposit of title deed of the asset and is followed as the stamp duty is minimum and negligible(Rs 100 for any value of the property) and has been designed so to encourage business and industrial growth. The English mortgage or simple mortgages attracts duty ranging from 5% to 10% of the value depending on states where it is located.
Documents of title or title deed in case of mortgage by deposit of title deed shall be the document or instrument which relates to the owner ship of the mortgager over the property. Article 62 of the Indian limitation Act-1963 provides limitation period for filing of suit for recovery of bank dues, mortgaged debt. The limitation period for filing a suit of sale of mortgaged property is twelve years from the date the mortgaged debt became due. The limitation period for filing for fore closer is thirty years from the date of money secured by mortgage becomes due.

Assignment-It is a type of charge on certain securities offered to a creditor. It is transfer of right for a property or debt. Usually book debts and future receivables are assigned where the bank has right to recover the sales proceeds directly from the customer of assigner. Document- “Equitable assignment agreement” is the document that is executed on stamp paper and the time period is 3 years. Whenever new bills are lodged for export new documents need to be taken.

Lien-Section 171 of the Indian contract act 1872 gives the banker the absolute right of general lien on all goods and securities received by the banker. The banker has general lien on all deposit till the debt or loan is fully paid. This is an agreement like deed and is on a prescribed format legally designed by banks. The time limitation is three years and in case of extension new document is taken.

Question No. 2 (b)

You are working as a bank manager and have received a loan proposal for a large industrial sector related to setting up a thermal power plant. The total loan requirement is Rs 10,000 Crores which for a single bank is not feasible. What step you will take to see that the requirement of Rs 10,000 Crores is met? (10 marks)

Answer:

In case of large advances there is a problem of financing by single bank and consortium financing is the only way out. For banks it is dangerous to keep all the funds in one basket. The originating bank here stands as a leader and a group of several banks form a consortium and take the decision jointly. This helps in limiting the liabilities of each bank. Also in case of failure the risk is divided depending on the exposures of each bank. In this case since it a large amount of loan a single bank in case of failure of advance or loan account turning NPA or sick (example-King Fisher) the single bank will be badly affected. In case of this advance of Rs 10000 crore, it may not be possible for a single smaller bank to meet the requirement and in case of failure the single small bank itself may turn sick or may vanish though there are restrictions of exposure and limitation of investment etc. In this case it becomes necessary to involve several banks to form a consortium and you as branch manager may lead and convince in creating a consortium.

To summarise it, banks lend under consortium finance on account of:

- Regulatory requirement-limitation of exposure (RBI- guidelines).
- A part of risk management and diversification policy of the banks.
- Restriction on single and group borrower limits.
- At the request of borrower himself.

In case of consortium finance, based on a formal agreement between member banks of the consortium group , it would have identified a banker as “LEAD BANK” who will act as a leader for the group and arrange meetings, prepare proposal including credit appraisal. He will also prescribe security and charge creation with ROC. The lead bank also helps in monitoring and control of account including timely performance reporting to all concerned.

Question No. 2 (c)

What are the problems faced by India in implementing BASEL committee report?

(10 marks)

Answer:

Problems faced by India in implementing BASEL III report are as under:

Basel as a whole is based on three principles of risk management in banking system globally. For Basel members these were-

i) Credit risk
ii) Market risk.
iii) Operational risk.

The Basel III has put very tough lines to be observed for which huge capital and organisational structure and training is required. Information, communication and data mining system have to be fast, accurate and to fit in to Basel format.

The three pillars of Basel II have been kept stronger to meet the challenges created by national and international risks. Problems faced by India are:

Minimum capital requirement (capital adequacy)- the capital requirement as recommended are based on credit risk (standard Approach and internal rating approach), operational risk and market risk. To cover all these Indian banks need infusion of large funds and regulating the standardised approach.

The supervisory Review Process- it has been made very tight for which recommendation is to cover transparency and accountability. It also covers the treatment of interest rate risk in the banker's book. Credit stress testing, credit concentration risk and enhanced cross boarder risks have also been imposed.

Under supervisory control, maintaining minimum regulatory capital ratios is difficult as the Basel-III-capital adequacy is not possible at this stage.

It will take time to reform Indian banking system, mainly on account of capital raising, process of credit risk system and tough supervision and control that needs reform including accurate and fast data analysis and communication system.

RBI has given guidelines to the Indian banking system to adopt Basel III norms at a gradual scale and try to achieve it by 2018. Once it is achieved the banking system in India will be able to face challenges caused by risks and will be able to remain stable even under strong jerks caused by risks faced in future.

Liquidity Coverage Ratio and risk monitoring tools- In India, LCR is to be implemented by Jan. 2015. The NSFR (Net Stable Funding Ratio) shall be maintained by Jan 1, 2018 because Indian Banks will need time to touch the NSFR as desired by BASEL III.

Basel III needs good amount of capital to be inducted gradually by Indian banks to touch the international standards and will take time to do so. Once Basel standards are met the Indian banks will enjoy the international competitiveness and stability and strength to fight risks of all kind.

Question No. 3

For a quick and honest grievance redressal 'Banking Ombudsman' was created. Discuss the objectives of Ombudsman and type of grievances generally covered under it. Is it advantageous to the society and will it acts as a tool to create a healthier and an ethical customer relationship? Support your answer with suitable examples where help from 'Banking Ombudsman' can be taken. (5 marks)

Answer:

Banking Ombudsman Service is a body that settles the grievances of public related to the banking system in India. It deals with the complaints mainly that concerns with the deficiencies in services in regard to banking. It is appointed by the Reserve Bank of India under RBI's Banking Ombudsman Scheme 2006 (Sec.35A of BRA-1940).

Grievances generally covered:-

- Deficiencies in customer services like; non acceptance of notes of lower denominations without adequate reasons and charging commission for it.
- Delayed or non-payment of remittances and issuance of drafts.
- Prescribed laid down norms for working hours not followed.
- Opening of accounts without valid reasons refused.
- Closer of deposit account without sufficient notice and reasons.
- Closure or delay in closing account refused.
- Violation of directions issued by the RBI in relation to banking or other services.
- In regard to loans and other advances, non-observance of interest rate, delay in sanction etc., not followed by the banks.

Advantages of Ombudsman to the society-

Several people working with the banks do face unnecessary problems and before the introduction of Banking Ombudsman (2006) the society used to suffer a lot. There were delays in settling issues and it used to take long time and in several cases people used to take help from courts. To summarise following were the advantages to the society-

- Timely decisions within 30 days.
- Quick implementation with confirmation to Ombudsman.
- Mostly right and proper decisions.
- It acts as guardian for the people.
- Earlier customers used to wait for decision and used to run from pillar to post but it has been seen that after a customer moves to Ombudsman the banker start moving fast in their action.

- It does not bear any cost to public.

Generates an ethical relationship- no doubt the improvement in wrong practices or delayed decisions and refusal of services resulted in to an ethical and healthier relationship between the bank and customer. The existence of Ombudsman at the top has created a discipline among banks in dealing with a customer. May be it is due to fear or minimising the cases referred to Ombudsman by the customers, the quality of services has improved.

In other side, the customer's confidence was built thinking that some legal guardian is sitting on the top with authority. The creation of ombudsman has also created fear and discipline in banking system leading to better services by the bankers by acting within RBI's guidelines.

Question No. 4

Mechanisation and e-banking has provided speed and comfort for both the banks and the customers but at the same time it has generated risks. Discuss the risks associated with e-banking and your suggestions to minimise it. Give suitable examples of risks possible in e-banking system and its control mechanism. (5 marks)

Answer:

Mechanisation of banking using hard wares, softwares (Bank-Master etc.) and internet-ting helped in quick, accurate and faithful banking resulting into comfort, peace in the mind and time savings for individual and the country's man-power. Due to very larger volume of operations and little weaker elements in the system, apart from providing comfort and speed to perform, it has generated some risks for the bank and customers as well.

Today the introduction of e-banking and e-commerce (businesses) has brought speed in communication and data transfer. The distance and location have shrunk and all have been linked globally as a small-village. The computer and computing has become the vital component of life but at the same time it has brought some problems by creating some space for cyber-crime that is posing a significant threat. Cybercrimes are designed and acted upon by technically competent criminals who penetrate into the e-system to perform their criminal activities.

Risks associated with cyber crimes:-

- Financial loss breaking the e-system.
- Sabotage and theft by cloning ATM cards.
- Infringement of confidential information.
- Cloning of credit cards.
- Other operational risks.
- Thieves forcing at late night hours to operate ATMS and surrender the amount.

Suggestions to control-minimise or eliminate cybercrimes:-

Following are the important suggestions to tackle cybercrimes:

- Do not allow easy access to data.

- Protect storage of sensitive data and information and do not disclose even to your friends or near-one.
- Take precautions while operating the system.
- Keep on changing the password within one or two months.
- There are latest software kindly add it to your system.
- Banks should plan programs to educate customers, because most of the cybercrimes are caused due to common negligence on the part of user.
- Lack of internal control in organizations and banks should ensure that the on-going internal control and IT audit system is created and followed.
- The IT auditor should certify about the sensitivity, integrity and security of the system.
- There should be an effective control to avoid unauthorized access and a dual control is preferred.
- The staff of banks should not work at the same counter for a longer period. Keep on rotating them.
- Staffs who have served at the same city for more than three years should be transferred at a different location.
- Educate employees and customers by holding seminars using experts.

Question No. 5

In the year 1935 Reserve Bank of India Act was framed and after independence the Banking Regulation Act 1949 was created. Describe the reasons of this change and important provisions built in it. Explain how this Act is going to strengthen the banking system in India.

(5 marks)

Answer:

Before introduction of Banking Regulation Act 1949, the entire banking system was guided in accordance with the Banking Company Act and Reserve Bank of India act-1934. After independence a detailed and comprehensive act was formulated and was termed as "Banking Regulation Act-1949".It covered wider and almost all activities of banking. It provides detailed and comprehensive guidelines to banks covering wider range of operation's area.

Some of the important provisions of Banking Regulation Act-1949 are:-

- Sec. 5 (i)- defines banking-acceptance of deposits and lending money etc.
- Sec. 5 (i)(f)-it deals with demand and time liabilities-the demand liabilities are payable on demand.
- Sec. 5(i)(b)- covers the details about secured loans and advances. Secured loans are those loans against which there is adequate asset of good market value that cares as a security for loans in case of failures.
- Sec. (6)(i)-this section defines the banking business and limits the boundary of banking activities.

- Sec.(7)-it provides details of banking companies that covers banking business. It makes it mandatory to use “banking” word in their name as well.
- Sec.8- trading of goods.
- Sec.9- Prohibits certain activities like holding of immovable properties.
- Sec. 14-prohibits creation of charges on unpaid capital and sec.14 (a) prohibits that a banking company cannot create a floating charge on any property of the company (BANK) without prior permission of RBI.
- Sec.11 and 12 deal with the capital reserve of the banks.
- Sec.18-details about CRR have been provided under this section.
- Sec. 19 (2)- specifies about shareholding of a banking company. No banking company can hold share in any company.
- Sec. 24 covers all about SLR as notified by RBI from time to time in the form of cash, gold-reserve and unencumbered securities.
- Sec. 29 stresses that every bank has to publish its audited balance sheet.
- Sec.30 (i) makes the audit mandatory by a qualified auditor (CA).
- Sec.35-Provides power to RBI to inspect banks.
- Other sections deal with standards set about submission of returns on prescribed format on monthly, quarterly and yearly basis to RBI to have control over performances of banks. This section deals with the control mechanism.

Question No. 6

a) What is Garnishee order and where is it applied? Narrate two situations where the Garnishee order will not be applicable.

b) What are the uses of Right of General Lien and Right of Set Off? Give an example of Right of Set Off. (5 marks)

Answer 6(a):

a) Garnishee Order-

A bank is obliged to honor its customer’s cheques; but it is extinguished on receipt of an order of the court and this order is termed as ‘Garnishee Order.’ The garnishee order is issued under order 21, rule 64 of the code of civil procedure 1908.

Condition-If a debtor fails to pay the debt owed by his creditor, the creditor may approach a court to issue a garnishee order on the banker of his debtor. Such order attaches debts not secured by a negotiable instrument resulting to stopping of payment. The account of such customer becomes suspended and banker is obliged not to make payment from the account concerned or related to garnishee order. The creditor under whose request the order is issued is called the judgment creditor and the debtor whose money is frozen is called the judgment debtor and the banker who is debtor of the judgment debtor is called garnishee.

In it there are two parts of judgment. One is stop payment called Order Nisi. It helps banker informing the concerned party. Later on the bank puts the explanation and details in the court. The court may issue the financial order called Order-Absolute where the entire balance in the account is attached. On the receipt of judgment order, the banker is bound to pay the garnished fund to the judgment-creditor.

Answer 6(b):

Uses of right of general lien:

Right of general lien means the right of the creditor to retain the goods and securities owned by the debtor unless the debt dues from him are paid off. Its uses are-

a) It is used by banker as a security against its liabilities.

b) It is tantamount to an employed pledge and it confers on the bank, the power to sell.

c) In case of failure to pay, the bank may sale the goods to recover or liquidate the liabilities.

d) The same lien can be extended for other liabilities as well after the primary liabilities are liquidated.

e) The lien can be used for any other liability of the bank also.

Right of Set-off: Following are the conditions in regard to the right of set-off.

1) The banker, like other debtors possesses the right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance of one account from the credit balance of another account, both related to same customer.
2) It widens the security of bank loans operated through the accounts by the same person.
3) The right of set-off can be exercised by the banker if there is no agreement-expressed or employed. A notice is served to the customer about the intention to exercise the right of set-off. Usually a letter is obtained by the banker in the beginning itself which is known as a letter of set-off.
4) In case there is a firm name the set-off can be applied to individual owner of the firm.
5) It is used for debt dues and not for future debt.

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