Journal Section

A Critical Evaluation of Legal Reforms Mitigating Banking Crisis*

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CHAPTER - 5

CENTRAL BANKS EXPERIENCES - REMEDIAL MEASURES

Central Bank is the agent of the Government and Government is run by the public representatives. Therefore, any discussion of banking law must review the public interest served by the bank regulator as agent of the state.

5. Need for Supervision and Regulation : Recent Experience

The need for regulation and supervision in different economies of the world may be illustrated by the following facts:

According to reports (Banker, August 1998) US regulators are becoming worried about a slackening in lending standards among bank which could threaten a repeat of past bad debt crises.

Both the Federal Reserve and the Office of the Comptroller of the Currency (OCC) reported on the results of their latest studies of their lending practices. The two lending supervisors have issued instructions and guidance to bank examiners and managers in an effect to avoid new meltdown.

Banking problems surfaced in Indonesia in September 1997 and before approaching the IMF, the authorities closed down 16 large banks in the country. The state of financial affairs in Japan and Korea is also serious.

The recent news of bankruptcy of Peregrine Investment Holding, the premier Asian investment bank, has obviously sent shock waves among the merchant/investment banking community across the globe.

PREVENTING AND MINIMIZING CRISES

5.1 Remedial Measures

Most banking laws empower the bank regulator to require a bank in violation of one or more prudential standards to take remedial measures designed to bring the bank back into compliance, often within a period of time specified by the regulator.

In authorizing or requiring remedial measures, banking laws follow different patterns. Many banking laws have couched the provisions authorizing the bank regulator to order remedial measures in permissive terms leaving it to the discretion of the regulator in each case to decide whether or not and if so, which - remedial measures will be ordered. Others prescribe remedial measures in mandatory terms requiring the regulator or the non-complying bank to take action whenever a level of non-compliance described in the law has been reached.

5.2 Discretionary Remedial Measures

Some banking laws contain a broad general provision for the regulator to order the bank to take remedial measures, without specifying in the law what these measures may be.

Thus, for instance, Article 43 of the French banking law provides:

When justified by the condition of a credit institution, the Banking Commission may issue an injunction ordering the credit institution inter alia to take, by a specified deadline, all measures necessary to restore or reinforce its financial condition or to correct its methods of operation.

Other banking laws contain detailed lists of remedial measures . Thus the regulator may issue and publish written warnings, call meetings with the bank's management and owners to agree on remedial measures, issue written orders to the bank to cease and desist from certain activities, to dispose of certain investments, to suspend dividend payments, suspend untrustworthy and unresponsive bank managers or order their resignation, order owners of the bank holding a significant interest in the bank whose influence is judged to be detrimental to dispose of their shares, or suspend their shareholder voting rights, impose fines on the bank, appoint an advisor for the bank, appoint an observer to supervise management and to report to the regulator, have a special external audit performed, attach conditions or restrictions to the banking license of the bank, appoint a provisional administrator, and ultimately revoke the banking license of the bank (for example under RBI Act and B R Act; Reserve Bank of India is empowered to issue directions to the bank in public interest directives) . Not all banking laws specify all these measures; however, the lists are often accompanied by a provision granting general powers to the bank regulator, which would support their interpretation as illustrative in those cases.

In some countries, the law reinforces the authority of the regulator. For instance, the Swiss banking law contains the following provision:

Where, notwithstanding a prior warning, an enforceable decision of the Banking Commission is not observed within the deadline specified, the Banking Commission may itself, but for the account of the non-complying bank, take the measures that it had ordered.

In Canada, the law permits the regulator to apply for a court order requiring the bank to comply with the regulator's instructions.

5.3 Liquidity Support

Just like others, banks must ensure that they are able to meet their liabilities as these become due. Compared with other companies, however, banks face special difficulties in meeting this requirement. Traditionally, banks use funds received by them mainly in the form of demand deposits and short-term borrowings in the financial markets to make medium - to long-term loans. The resulting mismatch between the maturities of a bank's loan assets and its funding liabilities requires a bank to manage its resources with care so that it has sufficient liquid resources to meet its currency payment obligations. Accordingly, prudential banking regulations usually require banks to maintain certain levels of liquid resources that are measured as a fraction of their short-term obligations or that observe certain maximum time spreads between maturity classes of assets and liabilities. Because of the maturity mismatch inherent in a bank's operations and because not all a bank's loan assets can be readily sold for a reasonable price, these liquidity requirements cannot guarantee that a bank that complies with them will always be able to meet its liabilities as they fall due. Therefore, prudential liquidity requirements are usually set so as to enable the banks to meet their current liabilities in what are considered normal conditions.

It is in such situations that the central bank would provide support to the bank in difficulties as "lender of last resort," especially, to preempt or to save off a run by depositors and other creditors on the bank. Generally, however, central banks provide such liquidity support only to solvent banks, i.e. banks whose assets have a value that exceeds the aggregate nominal amount of their liabilities.

5.4 Mandatory Remedial Measures

In some countries, the banking law contains mandatory provisions and requires the bank regulator to take or impose corrective action. Thus, for example, in Switzerland, the Federal Banking Law provides:

Article 23 (1) When the Banking Commission discovers violations of the law or other irregularities, it must take the necessary measures to restore the rule of law and to remove such irregularities .

A more extreme form of this mandatory approach can be found in the United States. The severe savings and loan crisis of the 1980s and the suspicion that the crisis had been worsened by lax banking supervision prompted the U.S. Congress to adopt the FIDIC Improvement Act of 1991. The Act includes under the heading "prompt corrective action" a relatively long and detailed list of violations and corrective action" a relatively long and detailed list of vi olations and corresponding remedial measures that the bank or the bank regulator is required to take. Thus, the Act defines five levels of capital adequacy for banks, ranging from "well capitalized" to critically undercapitalized" and prescribes for each level a mandatory course of corrective action.

The question is whether such a mandatory regime produces better results than one that is discretionary. It cannot be denied that a mandatory regime creates an appearance of predictability and equality of treatment. After all, discretion can easily turn into permissiveness and lax banking supervision, especially in societies with a club culture. This is particularly so because the effects of regulatory corrective action on the name and credit rating of a bank can be devastating.

However, mandatory banking law provisions requiring the regulator to impose certain remedial measures are no panacea either. The principal weakness of a mandatory system, such as the U.S. system of "prompt corrective action" is its methodology of eliminating or restricting regulatory discretion and prescribing in its stead uniform remedial measures for all banks that have reached a certain state of noncompliance with the banking law, regardless of whether such measures are appropriate . In the light of prevailing economic conditions. Theoretically, under extreme circumstances, a mandatory remedial system could produce a wholesale closure of the banking-system.

5.5 Timeliness of Remedial Measures

In practice, there seems to be a tendency on the part of bank regulators to postpone remedial action against wayward banks. Although there are bad reasons for such delays - political interference in the regulatory process and a club culture are among them - there is at least one proper reason for caution: a regulatory slap on the wrist, not to mention more severe sanctions, may adversely affect the bank's reputation and standing in the financial markets, and therefore its funding costs. Remedial measures could have the unintended effect of depriving the bank of financing on which its rehabilitation depends. Prudential medicine has side effects that can kill the patient.

The provisions of American law requiring banks in distress and the regulator to take prompt corrective action have been written with these considerations in mind. In essence, their chief advantage is that they require an early and graduated remedial response to banking deficiencies. In contrast, the law of England seems to limit the use of most remedial measures to cases where the banking license is to be restricted or revoked by the regulator. Remedial measures affecting the banking license are very serious steps that can hardly be kept from the public domain, raising the specter of an undesirable market response. Unfortunately, there is scant evidence that this greater danger has produced greater compliance with prudential regulations by banks in England.

5.6 Passive Regulatory Involvement in the Management of a Bank

Some banking laws provide for the bank regulator to become involved in the management of a bank that fails to comply with the banking law or fails to carry out remedial measures ordered by the regulator. This category ranges from passive involvement in the management of the bank through the appointment of a supervisor or inspector, to taking active regulatory control of the bank through one or more administrators or conservators.

Where the law permits regulatory control of a bank, the law may provide that the decision to take control may be taken by the regulator. Otherwise, that decision must be taken by another authority, such as the Minister of Finance (Austria and Italy) or the court (Luxembourg).

5.7 Appointment of an Observer

At the least intrusive level of involvement in the affairs of a bank, the Swiss banking law authorizes the bank regulator to appoint an observer to a bank, whose task is limited to supervising and reporting to the bank regulator on the activities of the bank; the observer may not intervene in the bank's business .

Similarly in Germany, the bank regulator may appoint a supervisor for a non-complaint bank. The supervisor attends management and shareholder meetings and is consulted on all important business decisions of the bank. However, his consent is not required for management decisions.

5.8 Appointment of an Inspector

In some countries, an inspector may be appointed whose prior authorization is required for all legal acts and decisions of the bank. Thus, the Belgian banking law provides that the bank regulator

… ..may appoint a special inspector whose general or special written authorization shall be required for any act or decision of a decision-making body of the credit institution, including the general meeting of shareholders and of all persons with managerial responsibility… . .

Under Dutch banking law, the appointment of an inspector must be preceded by a notice of non-compliance that may order corrective action; an inspector may be appointed only if in the opinion of the regulator the bank's response to the notice is inadequate or the bank fails to comply with the order.

The absence of consent of the inspector for acts and decisions of the bank may not be invoked against third parties unless the inspector's appointment was announced to the public, for instance, by entry in the public register of companies.

The control exercised by such inspectors falls short of bank management. The role of inspector or supervisor is a passive one, as he has only the right to give or to withhold his consent and may not initiate acts or decisions. The inspector does not have the power to enforce compliance by the bank with the law or the instructions of the regulator, not even where non-compliance is the principal ground for his appointment.

If the purpose of the appointment of an inspector is to restore the bank to health, more will be needed than the authority to disallow inappropriate transactions, especially if it concerns a large, modern, full-service bank. Rehabilitation of such an institution will require proactive involvement in all departments of the bank, for instance, to cut out waste, to close unprofitable undertakings or excessively risky positions, or to improve accounting, auditing and risk management systems and procedures. It is questionable whether an inspector with no managerial authority would be legally permitted to leverage his veto powers to such an extent that he could force the bank's management to initiate actions that he is not authorized to initiate himself. Moreover, if that were the legislative intent behind the appointment of an inspector, it would be more honest and efficient if the law were to grant direct managerial authority to the regulator or its representative.

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PART - III

LEGAL REFORMS - INDIAN CONTEXT

CHAPTER - 6

LEGAL REFORMS

Broadly speaking, the banking institutions in India, excluding the co-operative sector, can be classified into three categories viz. Public Sector Banks, Private Sector Banks and Foreign Banks. The public sector banks include State Bank of India, its subsidiaries and the nationalized banks, which are separate statutory corporations and coming under the statutory framework of their parent statutes. To state precisely State Bank of India (SBI) and its subsidiaries are the creation of State Bank of India Act, 1955 (SBI Act) and State Bank of India (Subsidiary Banks) Act, 1959 (Subsidiaries Act) respectively. Nationalised Banks are the corresponding new banks constituted under the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980 (Nationalisation Acts). The private sector banks are companies as defined under Section 3 of the Companies Act, 1956 and transacting the business of banking in India. The foreign banks on the other hand are foreign companies within the meaning of Section 591 of the Companies Act (i.e. companies incorporated outside India having a place of business in India) and doing banking business in India. The applicability of insolvency related provisions of law will also differ according to the legal regime in which each of these banking institutions fall.

As far as the banking companies are concerned since they being companies registered under the Companies Act, 1956 the provisions of the said Act are generally applicable. Moreover, the Banking Regulation Act, 1949 is an enactment not in derogation of the Companies Act, 1956 or any other law for the time being in force. However, the provisions of Banking Regulation Act, 1949 being a special statute on banking, will supercede the provisions of Companies Act, 1956 in case of any conflict between the two.

In dealing with the banking insolvency the present Indian legal system recognizes four major players viz. the banking company, Reserve Bank the regulator, DICGC for deposit insurance and the Central Government, subject of course with adequate mechanism for judicial review. The High Court having jurisdiction over the place of registered office of the banking company (in the case of a foreign bank the principal place of business in India) is empowered to adjudicate upon the insolvency matters dealt in Part III and Part IIIA of the Banking Regulation Act, 1949.

6. LEGAL REFORMS

The size and complexity of the world economy as also that of individual nation economies are growing at a fast pace. Today, therefore, it is a major concern for the managers of macro economies all over the world that foundations of their banking systems are sound and remain so in future.

At the advent of the liberalization, in India, need was felt to incorporate those safe guards which would prevent or at least minimize the banking crisis in the banking sector. In that direction the financial reforms were taken up in phased manner. The focus of these reforms was on building a strong and efficient banking system. The financial reforms were taken up in phased manner.

With the completion of the first phase of financial sector reforms, the following major changes have taken place in the bank's operating environment in the past few years.

? Deregulation of interest rates is more or less complete

? Gradual reduction in reserve requirements

? Move towards integration of various segments of financial markets

? Permission to banks to approach capital market for augmenting their capital base to meet capital adequacy.

? Autonomy in operational matters

? Freedom to formulate bank-specific loan appraisal methods.

? Introduction of new products and players in the market resulting in increased competition in the financial sector.

? Move towards capital account convertibility

? Enhanced use of information technology.

The success of the first phase of reforms catalysed the move towards the next phase. This phase focuses on internal consolidation of banks and covers organisational restructuring to match with the competitive environment. Among the important aspects of such re-engineering is asset liability management (ALM), risk management, greater penetration of technology and strategic management. At the individual bank level, it implies formulating strategies for improving allocative efficiency, management of risks and furthering competitive strength. This, in other words, would mean that the resources have to be optimally used for maximising profits, effectively supplemented by risk management, covering both assets and liabilities so as to sustain and improve the profitability of the bank.

The following are some of the important preventive measures implemented by the Central Bank/ Government to minimize the banking crisis in the background of the international experiences.

6.1 Asset Reconstruction

This is particularly serious in India where public sector banks carry a total gross NPA worth Rs.53,294 crore constituting 14 per cent of their total gross advances as on March 2000. It is contemplated that an Assets Reconstruction Committee (ARC) may be formed by a bank individually or by number of banks jointly. The assets in the doubtful and loss category, which are generally hard-core NPAs, should be identified and realisable value should be ascertained. The identified assets should be transferred to the ARC at the ascertained realisable value and ARC would issue NPA Swap Bond for this value for transferring bank. In case the ARC is constituted by banks, the staff from the bank should be deployed in the ARC to transfer the institutional memory regarding problem loans to the ARC and for the consequent rationalisation of the staff of the transferring bank. For the purpose of financing ARC, these should be treated at par with venture capital for tax incentives.

6.1.1 Mechanism of ARC

In simplest terms, an ARC is a company, which specialises in recovery and liquidation of assets. Restructuring of a bank through an ARC is completed in a systematic manner. First of all, it is examined that whether the troubled bank will be viable after the restructuring operation, within a short time span. This analysis is conducted keeping in view the likely macro economic environment during the relevant period. If the evaluation shows non-viability, it would be prudent to go for liquidation or merger rather than committing more funds. Once viability is established, valuation of assets should be undertaken. This is a complex process in as much as each loan should be valued separately. For instance, in the case of a performing loan, it would be necessary to assess, albeit in a crude manner, the risk of loss which may arise due to the likely borrower behaviour in the near and medium term. For instance, if the probability of default is 50 per cent, for a loan with a value of Rs.100 and a collateral value of Rs.80, the risk of loss will be 10. The assessment has to be suitably calibrated by way of arriving at most realistic market value of the securities on a specific date. The next stage is the creation of the ARC and recapitalising the "good bank". The ARC can be an independent institution or a separate subsidiary or may form part of the bank itself. The main objective of an ARC is to maximise the return from the transferred asset after meeting the operational and financial costs. Thus, an ARC undertakes a wide range of functions, such as, repackaging and securitisation of assets, sale of assets, participation in liquidation proceedings, management of assets and their improvement to maximise return therefrom. In the next phase the identified assets are transferred to ARC at the estimated realisable value. Considering that the financial and physical resources of the ARC may be limited, it is desirable to transfer only assets above a certain value, say Rs.1 crore. The remaining loans can be best handled by the bank itself. ARC takes necessary steps for sale or liquidation of all assets. However, the remaining non-recoverable assets are either transferred to a debt-collecting agency at a low price or may be written-off. The final phase relates to winding up of the ARC with its net worth being returned to the parent company. Therefore, the focus should be on the "good bank" having all the good loans and receiving income therefrom. Internal governance should be pursued vigorously so that the bank returns to profit and gains further strength by improving its capital.

6.1.2 Analysis

The ground realities in India are significantly different. About 46 per cent of the total NPA of the public sector banks is in the priority sector. In this segment, the likely average size of a bad loan is small and the number of defaulting accounts very large. The

ARC may not prove very effective in dealing with loans in this sector as such loans are spread out over a very large geographical area with concentration in rural areas. A bank with large network including rural areas is better placed for effecting recovery of these loans and much should not be expected from an ARC which will have a centralised presence. Similarly, in the case of NPA with the public sector, which constitute about 3 per cent of the total NPA, the government may play a direct role effectively. Thus, the focus of ARC will be limited to the remaining 50 per cent of problem loans. To maintain efficiency of ARC, it is advisable to transfer only large loans to ARC and, therefore, loans above a threshold limit should be transferred to the ARC. Within this segment, loans against real estate constitute a very small part and, therefore, the advantage, which was available to the ARC in USA and Sweden will not be available in India or any country with similar features.

6.1.3 Restructuring of Weak Public Sector Banks (PSBs)

The Working Group on Restructuring Weak PSBs (Chairman : Shri M.S. Verma), had concluded that a comprehensive restructuring strategy dealing with operational, organizational, financial and systemic aspects, would be the most appropriate for the three identified weak banks. Subsequently, the union Budget for 2000-2001 announced that weak bank-specific Financial Restructuring Authority (FRA) would be constituted, not an authority to deal with all weak banks put together as recommended by the Working Group. Under the proposed framework, the statutes governing PSBs would be amended to provide for supersession of the Board of Directors on the basis of recommendations of the Reserve Bank and constitution of a FRA for such a bank, comprising experts and professionals. The amendments would also enable the FRA to exercise special powers, including all powers of the Board of the bank. The Government would consider recapitalisation of the weak banks to achieve the prescribed capital adequacy norms, provided a viable restructuring programme acceptable to the Government as the owner and the Reserve Bank as a regulator is made available by the concerned banks.

6.2 ASSET LIABILITY MANAGEMENT (ALM)

The increasing internalization of banking operations engenders the possibility of a significant mismatch between assets and liabilities, which have adverse implications for liquidity and solvency of the banking sector. In this context, pro-active ALM assumes importance. Broadly, the objectives of ALM are to contain the volatility of net interest income and net economic value of a bank. The supplementary objectives would be to reduce variability in all target accounts including control of liquidity risk, and to ensure balance between profitability and asset growth. To realize these objectives, asset-liability managers must be guided by policies that specifically address the bank's overall ALM goals and risk limits, and also by information that relates directly to its asset-liability positions. Such risk management strategies would help to reduce the adverse effects of macroeconomic shocks on the soundness of the financial system.

Realizing the need for gap management in the operational framework in the affairs of commercial banks, RBI has introduced systems of reporting in ALM. Directors and Board of individual banks are now made to involve in the process of ALM by making reporting under the ALM system mandatory and ensuring approval of the Board on a periodical basis. All scheduled commercial banks have been suggested to set up an operative machinery to assess interest rate dynamics and maturity dynamics of assets and liabilities. Even though freedom has been given to commercial banks to evolve individual systems of reporting under ALM, a model reporting system has been suggested. Focus is now given to banks to formulate reporting systems on three functional areas of ALM: (1) Short Term Dynamic Liquidity of inflows and outflows in the time buckets of (a) 1 to 14 days, (b) 15 to 28 days and (c) 29 to 90 days, (2) Evaluation of Interest Rate Sensitivity on the basis of (a) Residual maturity of Assets and Liabilities as at the end of the given quarter and (b) maturity pattern of outstanding Assets and Liabilities at the end of the given quarter and (3) Analysis of Deposit-Mix at the end of the given quarter.

Given the increasing internationalization of banking operations, commercial banking operations are subject to significant mismatch between assets and liabilities with implications for several types of risks, such as, the interest rate risk, liquidity risk and foreign exchange risk which are likely to arise and need to be addressed. It may be recalled that draft guidelines on asset-liability management (ALM) were issued in September 1998 and on the basis of the feedback received from banks on the draft guidelines, the final guidelines were issued in February 1999 for implementation by banks from April 1, 1999.

Asset-Liability Management Committees (ALMCs) have been set up in all banks and are headed by Chairman and Managing Director/Executive Director to manage various risks from risk-return perspective. Besides, Management Committee or a specific Committee of the Board has been formed in each bank to oversee implementation of the ALM system and review its functions periodically.

The guidelines introduced two returns, viz., Statement of Structural Liquidity and Statement of Interest Rate Sensitivity covering liquidity risk management and interest rate risk management in respect of banks' dealings in rupee. As regards foreign currency risk, banks were advised to follow the instructions issued by the Exchange Control Department in December 1997 that introduced two returns, viz., Statement of Maturity and Position (MAP) and Statement of Interest Rate Sensitivity (SIRS).

In July 1999, the Reserve Bank advised banks to submit four returns with effect from the quarter ended June 1999. The two returns on foreign currencies, viz., MAP and SIR have been aligned in periodicity and time-buckets with the Rupee statements on Structural Liquidity and Interest Rate Sensitivity for the purpose of supervisory returns. Banks have been provided with structured formats for compiling these returns. Banks have started submitting the returns since the quarter ended June 1999.

Keeping in view the prevailing Management Information System (MIS) in banks and in the absence of high level of computerization, banks were advised to ensure coverage of at least 60 per cent of their assets and liabilities from April 1, 1999 and 100 per cent by April 1, 2000. In view of genuine difficulties expressed by a few banks, it was decided to grant extension to some of the banks, subject to their covering at least 80 per cent of business by April1, 2000 and 100 per cent by April 1, 2000.

The Reserve Bank embarked on a project to upgrade the off-site data base supervisory statistics with enhanced capabilities of processing of reports on risk exposures based on submission of returns on ALM, introduced for banks and all-India terms lending and refinancing institutions.

Considering the existing MIS and technical expertise, banks have been advised to adopt the Traditional Gap analysis as a suitable method for measuring interest rate risk. It is , however, the intention of the Reserve Bank to move over to the modern techniques like Duration Gap analysis Simulation and Value at Risk over time when banks acquire sufficient expertise and improvement in acquiring and handling of MIS. Banks are, therefore, required to stipulate a time frame for switching over to the new techniques. The switchover is for prescribing explicit capital charge for interest rate risk in the trading book.

6.3 RISK MANAGEMENT

Given the diversity and varying size of balance sheet items among banks as well as across the bank-groups, the design of risk management framework would need to be geared to meet bank-specific requirements, covering the size and complexity of their business, risk philosophy, market perception and the existing level of their capital. In other words, banks would need to evolve their own systems compatible with the type and size of operations as well as risk perception. While doing so, banks would need to critically evaluate their risk management systems in the light of the guidelines issued by the Reserve Bank and evolve an appropriate system to overcome the existing deficiencies and institute the requisite improvements.

The increased complexity in banking operations, and the need to prevent financial crisis of the type witnessed in East Asia, have necessitated continuous efforts towards strengthening the soundness of financial entities, and in particular, up gradation of risk management practices and procedures. As part of this, guidelines on Risk management Systems were issued in October 1999, providing essential details to enable the banks to put in place a comprehensive risk management system to take care of credit risk, market risk and operational risk. The guidelines show that risk management is a necessary condition for maintaining, preserving and enhancing financial stability in the context of the financial and structural reforms that are being undertaken. An important means for positioning appropriate risk management techniques is the MIS. Development and strengthening of MIS would require in the first place a strong data base, and other information sets, and secondly, application of data mining techniques and behavioural and technical relationships among different variables.

6.4 RISK BASED SUPERVISION

Considering the complexities of banking business and emerging product innovations with complex risk profiles, there is growing acceptance that a Risk Based Supervision (RBS) approach would be more efficient than the traditional transactions based approach. RBS entails monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. The instruments of RBS are off-site monitoring and on-site inspection supplemented by market intelligence mechanism.

However, off-site surveillance has gained primacy internationally in recent times, given the ease and promptness of monitoring. Therefore, the Reserve Bank has decided to gradually move towards a risk based approach to inspection. Apart from strengthening the risk modeling capabilities based on off-site data and associated research for 'predictive supervision', the overall compliance burden under the RBS framework is likely to be largely rationalized.

In India, as part of the new supervisory strategy piloted by the Board for Financial Supervision (BFS), the Reserve Bank set up an Off-site Monitoring and Surveillance system (OSMOS) in 1995 in 1995 in order to supplement the existing system of on-site inspections and to provide a means of closer and continuous monitoring of bank performance. Under OSMOS, banks are required to submit quarterly and half-yearly returns on several aspects of financial performance, including asset quality, capital adequacy, large exposures, connected lending, ownership patterns, etc. As a move towards further strengthening the off-site monitoring process, a second tranche of four returns covering liquidity and interest rate risk in local and foreign currencies has recently been introduced. A return covering critical information about the operations of Indian subsidiaries of banks has been introduced, effective quarter ended September 2000 as a move towards consolidated supervision of banking groups Standard reports and detailed individual and systemic analyses are carried out and shared with the Bank Monitoring Divisions of respective banks to initiate timely supervisory intervention.

Off-site surveillance in different economies has evolved over a period of time, depending on the country's financial system and their level of development. As the supervisory framework acquires greater sophistication, it is expected that the off-site surveillance will acquire greater prominence for developing policy positions that are both relevant and beneficial.

INSTITUTIONAL REFORMS FOR CAPACITY BUILDING

6.5 CREDIT INFORMATION BUREAU

There has been a widely felt need to establish a Credit Information Bureau (CIB) designed to obtain and share data on borrowers in a systematic manner for sound credit decisions, thereby helping to facilitate avoidance of adverse selection. This would also facilitate reduction in NPAs. In June 1999, a Working Group was constituted to explore the possibilities of setting up a CIB in India. The Group, in its Report submitted to the Reserve Bank, recommended the setting up of a CIB in India.

Based on the recommendations of the Working Group and realizing the importance of developing better institutional mechanisms for sharing of credit-related information, the Union Budget 2000-01 announced the establishment of a Credit Information Bureau. Subsequently, in the Monetary and Credit Policy of April 2000, the Reserve Bank advised banks and financial institutions to make the necessary in-house arrangement for transmittal of the appropriate information to the Bureau. The State Bank of India (SBI) has entered into a Memorandum of Understanding (MOU) with the Housing Development Finance Corporation (HDFC), with Dun and Bradstreet Information Services Ltd. And Trans Union International Inc. as foreign partners, to set up a CIB within the confines of the existing legislation. The work of preparing a master legislation to establish a full-fledged Bureau is underway.

6.6 PROMPT CORRECTIVE ACTION

Worldwide, there is an increasing movement towards building a safe and sound banking system, backed by a strong supervisory regime. This is in accordance with one of the Core Principles for Effective Banking Supervision, which mandates that banking supervisors must have at their disposal adequate supervisory measures, backed by legal provisions, to bring about timely corrective action. Such a phenomenon has prompted the supervisory authorities to consider the possibility of introducing a system of Prompt Corrective

Action (PCA) in India. The response has been dictated by two major considerations. The first is the responsibility of bank supervisors to identify problem banks at an early stage. The other is to monitor the behaviour of troubled banks in an attempt to prevent failure or to limit losses or contagion.

In view of the above considerations, a system of PCA with various trigger points and mandatory and discretionary responses by the supervisors is envisaged for the banking system in India. In addition to CRAR, two additional indicators, viz., 'Net NPA' and 'Return on Assets', reflecting asset quality and profitability, respectively, have been included under the broader PCA regime. Trigger points have been proposed under each of the three parameters, taking into account the practicality of implementation of certain measures in the Indian context. For CRAR, three trigger points have been proposed - CRAR of greater than or equal to 6 per cent, but less than 9 per cent; greater than or equal to 3 per cent but less than 6 per cent. For Net NPAs, two trigger points have been proposed - greater than 10 per cent but less than 15 per cent and above. For ROA, the trigger point has been set at less than 0.25 per cent. A discussion paper on PCA has been put on the Reserve Bank's web-site for wider circulation, inviting suggestions and comments from banks and others.

6.7 NON-PERFORMING ASSETS

The level of NPAs of the banking system in India has shown an improvement in recent years but it still remains high. The problem of NPAs is closely tied to the issue of legal reforms. The legal framework is a key ingredient for limiting moral hazard.

In India, the issues pertaining to legal framework have been examined by the Expert Group under the Chairmanship of Shri T.R Andhyarujina, former Solicitor General of India. The Group, in its Report submitted in February 2000 to the Government recommended, among other things, the creation of a new law granting statutory power of possession and sale of security directly to banks and FIs and adoption of the draft Securitisation Bill. It has also suggested the provision of additional avenues of recovery of dues to banks and FIs by empowering them to take possession of securities and sell them for recovery of loans. The Report is under consideration of the Government.

6.8 DEPOSIT INSURANCE

6.8.1 Evolution And Objective

The Deposit Insurance Corporation (DIC) was established by an Act of the Parliament on January 1, 1962. With effect from July 15, 1978, it took over the undertaking of the Credit Guarantee Corporation of India Ltd. - a public limited company promoted by RBI on January 14, 1971 and it was called the Deposit Insurance and Credit Guarantee Corporation (DICGC). The objective was to integrate the twin and related functions of giving insurance protection to small depositors in banks and providing guarantee cover to credit facilities extended to certain categories of small borrowers particularly those belonging to the weaker sections of the society.

6.8.2. Scope of Deposit Insurance

The deposit insurance scheme is applicable to all functioning commercial banks in India including branches of foreign banks, co-operative banks and RRBs. The scheme provides insurance cover to a depositor's accounts - current, savings and fixed - in aggregate up to Rs.100,000 in each insured bank in India in all its domestic branches. In fact until deposit insurance was introduced and even thereafter the impounding of cash balances and other reserve requirements were used by the Central Bank in India not only as instrument of monetary policy but also by way of depositor's protection against the banks going bankrupt.

Deposits of the foreign government, Central Government, State Government, inter-bank deposits held abroad are not covered by the insurance scheme and hence, these are to be excluded by the insured banks while computing the assessment of insurance premium payable to DI&CGC. In the event of the failure of an insured bank, the scheme protects only the interests of depositors of the bank; it does not protect the interest of creditors or shareholders of that bank.

6.8.3 Regulatory Issues

Regulatory restructuring has to be thought of. Here, one question that requires to be addressed is whether the deposit insurance agency would need to be hived off as a separate autonomous agency? The answer is negative, because : (a) it would result in duplication of supervisory activities, and (b) it would not command the same degree of reverence as RBI does. This reverence streams from the enhanced power, including moral suasion, RBI exercises over the banking sector. This has been the history and tradition. It is stated in a lighter vien that that "one of the most potent tools available to the Central Bank in time of distress is the Governor's eyebrow."

Finally, two more things need to be done. First, banks have to make adequate financial disclosures to its depositors and shareholders. Secondly, legislative changes and fundamental reforms of banking laws will have to take place not only for ensuring depositors interests but also for speedy closure of problem institutions.

6.8.4 Reforms

Reforming the deposit insurance system is a crucial component of the present phase of financial sector reforms in India. Accordingly, a Working Group was constituted by the Reserve Bank on Reforms in Deposit Insurance in India (Chairman : Shri Jagdish Capoor). The Group submitted its Report in October 1999. The major recommendations of the Group include : (i) fixing the capital of Deposit Insurance and Credit Guarantee Corporation (DICGC) at Rs.500 crores, to be contributed fully by the Reserve Bank; (ii) withdrawing the function of credit guarantee on loans from DICGC; and (iii) risk-based pricing of the deposit-insurance premium in lieu of the present flat rate system. The task of preparation of the new draft law has been taken up in supersession of the existing law.

6.9 SECURITISATION

Securitisation is used as a tool to minimize the liquidity risk. In India, securitisation dates back to 1991 when Citibank securitised auto loans and placed a paper with GIC mutual Fund. Since then, a variety of deals have been undertaken. According to some estimates, 35 per cent of all securitisation deals between 1992 and 1998 were related to hire purchase receivables of trucks and the rest towards other auto/transport segment receivables. These apart, SBI Caps structured an innovative deal in 1994-95, where a pool for future cash flows of high value customers of Rajasthan State Industrial and Development Corporation was securitised. The recent securitisation deal of Larsen and Toubro has opened a new vista for financing power projects. National Housing Bank (NHB) has also been making efforts to structure the pilot issue of mortgage backed securities (MBS) within the existing legal, fiscal and regulatory framework .

In October 1999, the Parliament was presented with amendment to the Securities Contracts (Regulation) Act that seeks to redefine 'securities'. The amended definition is broad and covers securitised instrumenets also. The results of the amendment, when finally adopted, is expected to bring securitisation public offers under the regulation of the securities regulatory body.

In future, financial entities will be judged more by the informal strength and capital base rather than by the external support from the central bank or the government. Market penetration of financial institutions in the area of loan origination in future will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time. As the structure of the financial system evolves over time, it is expected that securitisation will play a much more important role in the future.

6.10 LEGISLATIVE AMENDMENTS

The following are the few amendments proposed to the RBI Act, BR Act, DICGC Act etc. which are under active consideration by the Government :

6.10.1 Reserve Bank of India Act, 1934

To accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of financial system in the first changing world of modern finance.

a) Separation of debt management to monetary management

b) Streamlining of CRR provisions like removal of prescribed limits, determination of composition of NDTL etc., so as to accord operational flexibility to the Bank.

c) Regulatory powers to the Bank over money market instruments and its derivatives.

d) Enabling powers to the Bank to undertake Repo and reverse Repo transactions.

e) Regulatory powers to the Bank over electronic funds transfer and multiple payment system and settlement systems managed by outside agencies.

f) Free the Bank from legal obligation to buy and sell foreign exchange and vesting discretionary powers with the Bank.

g) Provision for sharing credit information with other regulatory bodies, central banks etc.

6.10.2 Banking Regulation Act, 1949

To enhance the regulatory and supervisory powers of RBI and to resolve operational problems based on the past experience in administration of the Act the following amendments to the Act are suggested :

a) The terms 'banking policy' to include 'prudential norms' to be followed by banks.

b) Banks to be permitted to take up new activities like equipment leasing etc.

c) To prohibit connected lending and advances to related companies by the bank.

d) To direct auditors to report violation/ contravention of any of the provisions of the Act and also to disclose such information in his report/balance sheet as desired by the RBI.
e) To provide legal supervisory protection to RBI supervisory action.

f) To supercede the Board of a bank by RBI.

6.10.3 Deposit Insurance and Credit Guarantee Corporation Act, 1961

It is proposed that the Corporation will be undertaking only Deposit Insurance activity in future and exclude the credit guarantee.

a) Levy of risk based premium for deposit insurance.

b) Cancellation of registration of insured banks for failure to pay premium.

c) Power to RBI to make application for winding up and liquidation of a banking company.

d) Giving power to Corporation to act as official liquidator.

6.10.4 Credit Information Bureau Act (Proposed new legislation)

To facilitate sharing and distribution of credit information among banks including co-operative banks and financial institutions.

6.10.5 Urban Banks Regulatory Act, 2001 (Proposed new legislation)

Legislative changes relating to supervisory framework for Urban Co-operative Banks based on the recommendations of the Madhava Rao Committee.

Setting up of a new supervisory body under the existing set up of dual control and which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. This apex body could be under the control of a separate high level supervisory board consisting of representatives of the Central Government/ State Government, RBI as well as experts and it may be given the responsibility of inspection/ supervision of UCBs and ensuring their conformity with prudential, capital adequacy and risk management norms laid down by the RBI. The new supervisory body is expected to be under the overall control of RBI.

Banking Sector reforms in India have been marked with conservative and gradual phasing of these reforms for implementation so that adjustment could lead to smooth transition of the banking system without causing undue disturbances in the financial sector. This approach has led banks in India for smoothly complying with prudential norms practised world over. Unlike recent South East Asian banking crisis which triggered the collapse of these economies, the Indian banking sector has regulatory framework with control mechanisms set in position. Reserve Bank of India as a central banking authority had approached the banking sector reforms in India with caution integrating the domestic financial sector gradually but steadily with the external economy.

CHAPTER - 7

CONCLUSIONS

On a detailed study of the national and international experiences in preventing the banking crisis, as discussed in preceding chapters, it may be observed that in case of crisis common measure adopted by almost all the central banks is to revive confidence among the public by resorting to lender of last resort measures. Therefore, every country which is desirous to keep its banking system strong and healthy may consider bringing legal reforms in the direction of conferring autonomy and independence to the central bank equipping with tools of measurers in tackling the crisis as soon as the warning indicators are surfaced. It is suggested that the management strategy for future of any bank should have three-pronged approach, a) effective credit management and recovery of NPAs, b) introduction of adequate risk management system and c) improving internal control mechanism.

Banking System requires a legal infrastructure that supports the enforcement of financial contracts. Banks must be able to realize what is due to them. If they have no recourse against the borrowers who default, borrowers will have reduced incentives to repay their loans. Even the inordinate delay owing to inefficiencies or bottlenecks in the legal system will have the same consequences. Only a well-defined bankruptcy procedure can provide incentive to repay it and improve asset recovery. In addition, governing political institutions must also respect legal procedures and not interfere in the operations of the banks or in the administration of laws and regulations including the enforcement of the Bank's rights.

Regulation aims at strengthening the other main factors that determined the soundness of a banking system viz. the operating environment, banks systems and procedures, internal control and market discipline by laying down suitable guidelines. The regulation by itself does not become effective unless adequate supervisory systems are also put in place. Supervision mainly involves ensuring compliance with the regulatory rules. It also encompasses an on going vigilance over developments in the market, their likely impact on the banks and adoption of suitable remedial steps. Supervisory responses may include adopting an appropriate mix of on-site and off-site supervision. The Hong Kong Monetary Authority (HKMA) is entrusted with the responsibility of promoting general stability and effective working of the banking system under the Banking Ordinance. A sound banking system will, therefore, call for appropriate legal infrastructure to support efficient conduct of banking business and stable macro economic environment.

More so, legal reforms should be aimed at keeping the system more liquid and restore its solvency and solvent. The legal reforms must be directed to a) restoring depositors confidence and protect some or all depositors, b) preventing hasty liquidation of assets, c) avoiding undue monetary fluctuations, d) preventing moral hazard, e) protecting solvent banks and debtors, f) protecting the payment system, g) minimizing budgetary costs (or cost to the insurance agency), and h) ensuring equitable distribution of losses.

The central bank being the watchdog of the interests of the public/depositors should direct its policies towards a) preventing any crisis and b) avoiding liquidation of the bank. The techniques narrated below, if implemented, would make the banking system efficient and competent in tackling the crisis or at least mitigating the consequential contagion effect on the economy.

The measures may be classified as follows :

Emergency Measures

? Financial support and other lender-of-last l Resort actions l Guarantees on deposits.

? Disclosure of information, e.g. to dispel rumors or to revive confidence

? Central bank intervention in management of weak banks

Long Term Measures

? New institution

? New legislation

? Strengthened supervision

Measures to Deal with Failing Banks

? Liquidation

? Merger

? Sale

? Recapitalisation l Restructuring

Measures to Deal with Borrowers

? Assistance to reschedule domestic debt

? Technical assistance

? Subsidies and assistance to foreign currency debtors

? Negative real interest rates.

The above measures adopted by the central banks, during the crises, evidences the need for suggesting safety valves to prevent or at least mitigate the banking crisis. The measures suggested in our study viz. asset reconstruction, asset liability management, risk management, banks structuring and deposit insurance, if implemented, with the suitable legal infrastructure would mitigate the contagion affect on the economy.

Safety Valves

The brief review of international experiences crystallizes the point that there is no standard mode or means of adopting the techniques of safety models in a compartmentalized manner e.g. there is no standard model for asset reconstruction and actual modalities and mechanisms are designed according to the specific situation of the concerned economy. In India, Reserve Bank has already initiated setting up of Asset Reconstruction Company which is waiting for the Government's approval. The ARCs would be vested with the powers to take over the defaulting borrowers' assets or management or both. However, care must be taken in overcoming the legal glitches in the given legal setup. In this regard Government's intervention and willingness to bring laws removing such hurdles is desirable e.g. transferring of debt to a corporation involves payment of stamp duty as per the existing provisions of the Stamp Act in India. Unless the Government exempts such transactions from levy of stamp duty it would be very expensive affair for individual banks and does not match with costs involved.

Reserve Bank has already issued detailed guidelines for risk management system in banks. The guidelines broadly cover management of credit, market and operational risk. The guidelines on risk management issued together with the ALM guidelines were purported to serve as a benchmark to the banks which were yet to establish an integrated risk management system. Banks operating in international markets were advised to develop by March 31, 2001 suitable methodologies for estimating and maintaining economic capital. Other banks should formulate a medium-term strategy to comply with these requirements. The Board of the banks are required to review the progress in implementation of the guidelines at half-yearly intervals.

Deposit Insurance

One school of thought opines that the introduction of deposit insurance scheme would reduce the depositors monitoring on the bank and central bank vigilance. Further it was viewed that the deposit insurance is more advisable for developing economies. It is not out of place to mention that the advanced and developed countries, even today have deposit insurance schemes e.g. USA, UK, Germany etc. Therefore, it is suggested that deposit insurance scheme is sine qua non of any banking system to inject confidence among public that would avoid run on banks. It is relevant to mention that in USA, more than 1600 commercial and savings banks insured with FDIC were either closed or given FDIC financial assistance during this period. The 1980s and early 1990s has witnessed great stress and turmoil for banks and financial institutions all over the globe, viz. Brazil, Chile, Indonesia, Mexico, several Nordic countries, Venezuela and USA, etc. Therefore, if the banks are not to be allowed to fail, it is essential that corrective action is taken well in time when the bank still has adequate cushion of capital so as to minimize the cost to the insurance fund/public exchequer in the event of a forced liquidation of the bank.

At this juncture, it may be suggested that a legislation fixing no limits of deposit insurance may be thought of that would strengthen the confidence of the public in assessing the financial viability of the bank. Such measures would force the regulator to be more vigilant in monitoring financial stability of the bank periodically.

In the recent past, there is a move to allow the private insurance institutions to cover the deposit risk in the banks. The advantage of allowing private insurance players in the place of existing deposit insurance scheme sponsored by the Government is that the depositors who are desirous to insure their deposits should have to pay their premium to the insurance companies instead of banks. This system would keep the depositor to be more vigilant and monitor the activities of the bank. Simultaneously, it reduces the financial pressure on the Government sponsored institutions viz. DICGC, in particular, where bank failures are frequent.

The Basel Committee had endorsed the need for supervisors taking timely corrective action when banks fail. Supervisors, as part of their duties, are responsible for making judgements on the health of individual institutions and the banking system as a whole. These judgements are sometimes difficult but are necessary to ensure that sick and weak institutions take the proper remedial action and, if they don't, are forced into prompt liquidation. If not, resolved promptly, problem banks become much more expensive to liquidate. Allowing a bank to fail is the tragedy that a supervisor should try to avoid, lest we may have to face the possible consequences of 'Misfeasance in Public - Life' : (Please see the House of Lords decision in BCCI's case).

The critical study undertaken above would reveal that reforms especially in the area of deregulation of interest rates and other regulatory reforms could have caused banking crisis as the banks were not ready to encounter the economic conditions prevailing during that time apart from major political uncertainties. Interest rate deregulation and other regulatory reforms took place long before the crisis in some cases and contemporaneously in others. The crisis periods were also marked by major external shocks, balance of payments difficulties, and the sharp adjustments in exchange rates and interest rates, although the balance of payments crisis occurred before overt manifestations of the banking crisis in some cases and afterwards in others. However, a common factor that can be observed from the past experiences is that legal reforms had prompted solutions to come out of the crisis . In late 1984, the Chilean government has introduced new regulations to return to more orthodox accounting practices. Also, since January 1983, the general deposit guarantee had been extended from time to time, and in June 1986, deposit insurance was granted only to domestic Chilean banks that met specified minimum capital requirements and only upon application by each bank. In November 1986, a new banking law was enacted that modified several key aspects of existing legislation in order to give formal status to existing supervisory practices, to further strengthen prudential regulations, and to streamline the deposit guarantee scheme.

To sum up it is suggested that the legal reforms should endow the bank regulator with operational and financial autonomy. A sound banking system is, therefore, the result of internal and external factors working effectively and inconsonance with each other. But at the same time the Government has a vital role to play in improving the soundness of a banking by making necessary amendments in laws.

In this context it is relevant to remember,

Everything can be improved - it is largely an attitude of mind - Baron

We need to do right things only and do them with excellence - Peter Drucker

Annexure A

Table 1 : Macroeconomic Conditions Before and During Banking Crises in Sample Countries

Country[1]	Growth of Real GDP		Inflation		Current Account Deficit/GNP		Investment Ratio		Terms of Trade (1980=100)		Real Effective Exchange Rate[3] (1980=100)	
	Before[2]	During	Before[2]	During	Before[2]	During	Before[2]	During	Before[2]	During	Before[2]	During
				(in percent)								
Argentina (1980-82)	3.1	–3.6	170.3	121.5	1.5	–3.9	12.8	19.0	88.9	99.8	65.0	81.2
Chile (1981-83)	8.1	–3.4	36.2	18.8	–6.6	–9.9	15.0	14.9	97.5	87.4	90.4	103.8
Uruguay (1982-85)	4.8	–4.2	51.6	47.6	–4.7	–2.2	16.0	10.6	102.1	92.7	90.9	81.4
Philippines[4] (1983-86)	4.6	–2.0	14.7	19.7	–6.0	–2.2	25.9	20.5	98.1	86.4	101.3	88.8
Thailand (1984-86)	5.4	4.1	7.2	1.7	–5.8	–4.6	22.7	20.5	87.6	82.6	105.8	95.8
Spain (1978-83)[5]	4.8	1.0	15.2	15.3	–1.8	–1.3	26.2	21.8	118.0	99.3	99.2	86.3
	(0.6)	(1.5)	(15.1)	(13.3)	(–2.6)	(–2.1)	(21.8)	(20.9)	(95.0)	(88.9)	(97.1)	(88.2)
Malaysia (1985-86)	7.0	0.1	3.8	0.5	–9.0	–1.2	35.7	26.4	82.9	72.1	113.9	101.5

Source : International Monetary Fund, *International Financial Statistics,* various issues, and IMF staff calculations.

[1]Years in parentheses refer to periods of major bank liquidations, interventions, and restructuring.

[2]Average of the three-year period before the year when the crisis started.

[3]A reduction in the index means a depreciation of the exchange rate of the domestic currency.

[4]There was a bill market crisis in 1981, with repercussions for the banking system.

[5]Although the banking crisis began in 1978, the peak years of the crisis were 1982 and 1983.

The figures in parentheses are the values when 1982-83 is considered the crisis period.

Annexure B

Financial Reforms and Financial Crises in the Seven Case Studies : An Overview

Interest Rate and Regulatory Reforms	**Deposit Insurance**	**Financial Crisis**
ARGENTINA		
Under the financial reform of 1977, interest rate controls were eliminated, branching and entry regulations were eased, and most selective credit controls were abandoned. Interest rate controls were reintroduced during 1982 and 1983. Prudential regulations were comprehensive and somewhat strengthened during the reform. Supervision of asset quality and on- site inspections, which had been inadequate, were strengthened following the crisis.	Before 1979 the Central Bank fully insured depositors and bore all costs. Partial coverage was introduced in November 1979. The maximum amount of insured deposits was indexed, and insurance premiums were set. Participation was voluntary. Amounts above the ceiling were insured only up to 90 percent. The maximum amount was adjusted retroactively following the crisis.	The crisis began with the failure of a large private bank in March 1980, leading to runs on three other banks that had to be intervened soon thereafter. Crisis spread rapidly to other banks and non-bank financial institutions; more than 70 institutions were liquidated or subjected to intervention between 1980 and 1982, accounting for 16 percent of the total assets of commercial banks and 35 percent of the total assets of finance companies.
CHILE		
The financial reform began in late 1973. Banks were privatized in 1984 and acquired by major conglomerates. Controls on interest rates were lifted in 1975, and selective credit controls were abolished. Entry and branching restrictions were removed. The system moved toward multipurpose banking, as distinctions among commercial, investment, mortgage, and development activities were abolished. Regulations on capital requirements were tightened and adjusted in line with inflation. Regulations, legislation, and supervisory apparatus aimed at controlling excessive risk taking and unsound lending patterns - given the interlocking ownership of financial firms - were weak or nonexistent until 1980. These deficiencies were rectified following the crisis. Also, since 1983 a suggested maximum interest rate on 30-day deposits has been used.	Explicit deposit guarantees were granted in January 1983, initially for a limited period. They were extended periodically until a formal deposit insurance scheme was instituted in 1986. There is partial insurance coverage for small depositors, with sight deposits fully protected.	The crisis began with the acceleration of business bankruptcies in 1980; a prominent sugar refining company failed in early 1981. Following bank runs in late 1981, the Government assumed control of three banks, a development bank, and four financiers, accounting for more than one third of the loan portfolio of the financial system. Again, in January 1983 seven banks and one financiers, accounting for 45 percent of total assets, were put under government control, and three were liquidated immediately. Central bank inspectors were placed in seven other financial institutions.
MALAYSIA		
All interest rates were formally liberalized in 1978, but effectively so in 1982. Controls on short-term deposit rates were temporarily imposed between October 1985 and February 1987. A ceiling on interest rate margins over the base lending rates was set in late 1987. Prudential regulations and supervision of banks were generally strengthened during reform.	No formal deposit insurance system exists.	The crisis began in July 1985 with short-lived runs against some branches of a large domestic bank, stimulated by rumors following the collapse of a related bank in Hong Kong. A spell of sporadic runs against weak institutions persisted throughout late 1985 and 1986, culminating in the failure of deposit-taking cooperatives in July and August 1986. This failure led the Bank Negara Malaysia (BNM) to intervene in 24 deposit-taking cooperatives with total

Interest Rate and Regulatory Reforms	Deposit Insurance	Financial Crisis
PHILIPPINES		
Financial reform began in mid-1980. In July 1981 all interest rate ceilings except those on short-term loans were lifted. In 1982 short- term loan rates also were freed. Before the reform (1972-81) interest ceilings were raised and adjusted on several occasions, but fees to circumvent ceilings were common. Between 1972 and 1980 entry of domestic banks was tightened and mergers were encouraged by higher capital requirements, while foreign bank entry was eased. In 1980 universal banks were authorized and activity restrictions on thrift banks were relaxed. Prudential regulations and supervisory apparatus were generally comprehensive. Regulations were strengthened in some areas(e.g., capital adequacy) but relaxed in others (e.g., loans to related interests) during the reform period, but the enforcement of powers and regulations was weak.	A formal deposit insurance scheme has existed since 1970, but the scheme experienced difficulties in settling the growing claims in 1981. It was recapitalized in 1985. As of June 1987, only 52 percent of all claims on insured deposits had been settled.	The first episodes of the crisis were in 1981, when the commercial paper market collapsed owing to the dishonored bills left behind by the textile magnate Dewey Dee, who fled the country. This collapse caused a major confidence crisis, triggered failures and takeovers of non- bank money market institutions, and resulted in a spread of distress among non-financial firms. Also between 1981 and 1983, failures among rural and thrift banks (these banks account for only 9 percent of the assets of the financial system) accelerated; government and central bank assistance to troubled financial and non-financial firms continued at high rates in 1982 and 1983. Failures of thrift banks accelerated in 1984 and 1985. Three private banks were liquidated in 1985 and 1986. In all, between 1981 and 1987, 126 rural banks, 32 thrift banks, and 3 commercial banks closed down. These, however, accounted for only 3.5 per cent of total financial system assets. In addition, 2 large state-owned banks and 5 private commercial banks accounting for 32 percent of total financial system assets required financial support, subsidies, and restructuring in 1985 and 1986. The 2 government-owned banks were effectively liquidated and bailed out, with their non-performing loans (about 30 percent of the banking system's assets) transferred to a separate agency in 1986. The 5 commercial banks are undergoing rehabilitation under the Central Bank's supervision.
SPAIN		

Financial reform began in 1974. Interest rates were liberalized gradually, starting with the longer maturities. By the beginning of 1981, all interest rates were free, except for some specified priority categories and short- term deposit rates. The latter were freed in 1987.

Activity regulations were eased and entry regulations were streamlined and liberalized.

Bank secrecy laws were drastically modified; commissions and fees were freed. Prudential regulations were comprehensive and in some cases very detailed, but proved difficult to implement. Supervision was weak.

In November 1977 deposit guarantee funds were established - one for each group of institutions - within the Bank of Spain, offering protection to small depositors based on contributions from financial institutions. Separate Guarantee Funds were organized on March 28, 1980, with the Bank of Spain matching the premiums contributed by banks. The maximum size of an insured deposit was adjusted several times.

A protracted banking crisis began in 1978, when the Bank of Spain had to rescue one of the smaller banks in distress. Between 1978 and 1983, a total of 51 problem banks, accounting for about 19 percent of the total assets of the banking system as of the end of 1977, required intervention and appropriate disposition decisions. The peak of the crisis came in 1982 and 1983, when two large banking groups, owned by large industrial conglomerates, had to be taken over or temporarily nationalised. Two banks were closed; all others were either sold by the Deposit Guarantee Fund or taken over by stronger institutions.

(See V. Sundararajan and Thomas J.T. Balino, Banking Crises : Cases and Issues, International Monetary Fund, N.W. Washinton D.C.)

Annexure C

Basle Core principles. Principle Nos. 6 to 15 relate to risk management, prudential regulations and requirements.

Capital adequacy

Principle 6 : Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

Credit - granting standards and credit monitoring process

Principle 7 : An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Assessment of asset quality and adequacy of loan loss provisions and reserves

Principles 8 : Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

Concentrations of risk and large exposures

Principle 9 : Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposure to single borrowers or groups of related borrowers.

Connected lending

Principle 10 : To prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's -length basis, that such extensions of credit are effectively monitored and that other appropriate steps are taken to control or mitigate the risks.

Country and transfer risk

Principle 11 : Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities and for maintaining appropriate reserves against such risks.

Market risk management

Principle 12 : Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks, supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Other risk management

Principle 13 : Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate Board and senior management oversight) to identify, measure, monitor and control all other material risk and, where appropriate, to hold capital against these risks.

Internal control

Principle 14 : Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 15 : Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, the promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally by criminal element.

Annexure D

Table : International Deposit Insurance system

Country	**Insuring Agency**	**Year**	**Membership**	**Administration**

Argentina	Deposit Insurance Scheme (Central Bank)	1979	Voluntary	Officially sponsored and administered
Austria	Deposit Guarantee Fund	1979	Compulsory	Industry arrangement
Belgium	Rediscount and Guarantee Institute	1985	Voluntary	Officially sponsored and administered
Brazil	NA	1989	(.)	Joint administration
Canada	Canada Deposit Insurance Corporation	1967	Compulsory	Officially sponsored and administered
Chile	Superintendent of Banks and Financial Institutions	1986	Voluntary	Officially sponsored and administered
Columbia	Financial Institutions Guarantee Fund	1985	Compulsory	Joint administration
Denmark	Deposit Guarantee Fund	1987	Compulsory	Industry arrangement
Finland	Deposit Guarantee Funds	1969	Compulsory	Industry arrangement
France	Deposit Guarantee Fund	1980	Compulsory	Industry arrangement
F.R.Germany	Deposit Security Fund	1966	Voluntary	
	Savings Bank Security Fund	1969	Compulsory	
	Credit Co-operatives Security Scheme	1976	Compulsory	Industry arrangement
Ireland	Deposit Protection Account (Central bank)	1989	Compulsory	Officially sponsored and administrated
Israel	NA	NA	NA	NA
Italy	Inter-bank Deposit Protection Fund	1987	Voluntary	Industry arrangement
Japan	Deposit Insurance Corporation	1971	Compulsory	Joint administration
Kenya	Deposit Protection Fund Board	1985	Compulsory	Officially sponsored and administrated
Lebanon	NA	1967	Compulsory	Officially sponsored and administrated
Netherlands	Collective Guarantee Scheme	1979	Compulsory	Joint administration
Nigeria	Nigerian Deposit Insurance Corporation	1988	Compulsory	Officially sponsored and administrated
Norway	Deposit Guarantee Fund	1961	Compulsory	Joint administration
Paraguay	Sistema Nacional de Ahorro Y Prestamo para ta Vivenda	1971	Voluntary	Officially sponsored and administered
Philippines	Philippines Deposit Insurance	1963	Compulsory	Joint administration

	Corporation			
Spain	Deposit Guarantee Fund	1977	Voluntary	Officially sponsored and administrated
Sweden	Deposit Insurance Fund for Savings Banks	NA	NA	Industry arrangement
Switzerland	Deposit Guarantee Scheme	1984	Voluntary	Officially sponsored and administered
Trinidad & Tobago	Deposit Insurance Corporation	1986	Compulsory	Industry arrangement
Turkey	Turkish Deposit Insurance Fund	1983	Compulsory	Joint administration
U.K.	Deposit Protection Fund	1982	Compulsory	Officially sponsored and administrated
U.S.A.	Federal Deposit Insurance Corporation	1993	(..)	Officially sponsored and administrated
Venezuela	Bank Deposit guarantee and Protection Fund	1985	Compulsory	Officially sponsored and administered
Yugoslavia	NA	NA	NA	NA

(Source: IMF Working paper ' Post-Resolution Treatment of Depositors at Failed Banks; Implications for the Severity of Banking Crises, Systemic Risk, and Too-Big-To-Fail - *George G. Kaufman and Steven A. Seel)*

Gentlemen & Ladies and bald headed babies ! I have come before you to stand behind you To tell you something of which I know nothing On this Thursday, which is a Good Friday There will be a mothers' meeting for fathers only Admission is free, Pay at the door Take a seat and sit on the floor Wear your Best clothes for I know you haven't any And now let me begin my story upside down One fine day in the middle of the night Two dead boys began a fight Back to back they faced each other Drew their swords and shot at each other And when a deaf policeman heard the noise He came to rescue the two dead boys And if my story is not believed by you Ask the blind man he saw too !

M – Mentally A – Affected T – Teachers H – Harassing S – Students

Referential Legislation
- Less Preferential ?

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Introduction

"Legislation by incorporation is a common legislative device employed by the legislature, when the legislature for convenience of drafting incorporates provisions from an existing statute by reference to that statute instead of setting out for itself at length the provisions which it desires to adopt" [1].

A large number of statutes have been enacted covering a variety of subjects. Some statutes refer to the existing statutes either for the definition of some expressions or for adopting some of their provisions. Such a reference has some advantage as repetition of identical provisions is avoided in the subsequent statutes. The case law on the interpretation of the adopted provision in one of these statutes could be helpful in interpreting that provision in the other. However, such references present difficulties in interpretation of the subsequent statutes if the provisions of the earlier statutes referred to therein are amended or repealed. The question that arises is whether the earlier statute as it stood at the time of the enactment governs the subsequent statute or whether the provisions of the earlier statute as amended upto date govern the subsequent statute. This paper goes through a few judgements to find solution.

1. P.N.Bhagawati J. in Mahindra and Mahindra Ltd. vs. Union of India another (1979) 2 SCC 529 = AIR 1979 SC 798.
2. Singhai Rakesh Kumar vs. Union of India (2001) 1 SCC 364; Gauri Shankar Gaur and others vs. State of UP and others. (1994) 1 SCC 92 = AIR 1994 SC 169; Bajaya vs. Gopikabai (1978) 2SCC 542 = AIR 1978 SC 783.

Reference to former enactment

2. Section 8(1) of the General Clauses Act 1860 (GCA) deals with construction of references to repealed enactments. The said Sec.8(1) reads as under.

> "8.Construction of references to repealed enactments. -(1) Where this Act, or any Central Act or Regulation made after the commencement of this Act, repeals and re-enacts, with or without modification, any provision of a former enactment, then references in any other enactment or in any instrument to the provision so repealed shall, unless a different intention appears, be construed as references to the provisions so re-enacted".

3. The rule laid down in Sec. 8(1) of GCA is that the earlier enactment as amended (repealed and re-enacted) and not the earlier enactment as it stood at the time of enactment of the subsequent Act, will govern the subsequent Act. However, this is subject to a different intention appearing from the subsequent legislation. The following words from Corpus Juris Secundum referred to by the Supreme Court[2] in some cases are also relevant in this context.

> "Where the reference in an adopting statute is to the law generally which governs the particular subject, and not to any specific statute or part thereof, the reference will be held to include the law as it stands at the time it is sought to be applied, with all the changes made from time to time, at least as far as the changes are consistent with the purpose of the adopting statute".

Incorporation

4. Courts have held[3] that the provisions of existing Acts incorporated in subsequent Acts by reference become part of the subsequent Act as though the said provisions were bodily lifted and repeated in the subsequent enactment. The natural consequence of this interpretation is that the subsequent amendments carried out in the earlier enactment will not affect the subsequent enactment. However, this rule of interpretation is also not without exception[4].

The Privy Council[5] held that where some provisions of Land of Acquisition Act 1894 had been incorporated in Calcutta Improvement Act 1911, subsequent amendment of Land of Acquisition Act 1894 could not be read into Calcutta Improvement Act 1911. Referring to Craies[6], it observed that, 'where a statute is incorporated by reference into a second statute, the repeal of the first statute does not affect the second". This has been referred to by the Supreme Court in many cases[7].

5. The main argument in support of this view is that at the time of enactment of the subsequent

3. Secretary of State for India in Council vs. Hindustan Cooperative Insurance Society Ltd., AIR 1931 PC 149; Mahindra and Mahindra Ltd. vs. Union of India & another (1979) 2 SCC 529 = AIR 1979 SC 798.
4. Please see para 6 *infra*.
5. Secretary of State for India in Council vs. Hindustan Cooperative Insurance Society Ltd., AIR 1931 PC 149.
6. Statute Law, 3rd edition page 349-350.
7. UP Avas Evam Vikas Parishad vs. Jainul Islam (1998) 2 SCC 467; Gauri Shankar Gaur and others vs. State of Up and others. 1994 (1) SCC 92 = AIR 1994 SC 169 : State of MP vs. M.V. Narsimhan (1975) 2 SCC 377 = AIR 1975 SC 1835.
8. Gauri Shankar Gaur and others vs. State of Up and others. (1994) 1 SCC 92 = AIR 1994 SC 169.
9. In re Wood's Estate, (1886) 31 Ch D 607 at page 615.
10. UP Avas Evam Vikas Parishad vs. Jainul Islam (1998) 2 SCC 467; Gauri Shankar Gaur and others vs. State of UP and others. 1994 (1) SCC 92 = AIR 1994 SC 169 : State of MP vs. M.V. Narsimhan (1975) 2 SCC 377 = AIR 1975 SC 1835; Onkarlal Nandalal vs. State of Rajasthan 1985 (4) SCC 404 AIR 1986 SC 2146; State of MP vs. M.V. Narsimhan (1975) 2 SCC 377 = AIR 1975 SC 1835.
11. State of MP vs. M.V. Narsimhan (1975) 2 SCC 377 = AIR 1975 SC 1835.

Legislation, the Legislature could not have imagined or comprehended what changes could be brought about in future in the earlier enactment. The Supreme Court has noted this proposition in the following words.

> "The legislature while incorporating them did not intend to speculate that any subsequent amendment to the previous Act or its repeal would alter the texture of the later Act, unless the previous act is supplemental to the latter Act or both are in pari-materia in which case it would render the later Act wholly unworkable and ineffectual or by necessary intendment applies it."[8]

The following observations of Lord Esher, M. R[9]., have been quoted in many judgements of the Supreme Court[10] with approval.

> "If a subsequent Act brings into itself by reference some of the clauses of a former Act, the legal effect of that, as has often been held is to write those sections in tho the new Act just as if they had been actually written in it with the pen, or printed in it, and, the moment you have those clauses in the latter Act, you have no occasions to refer to the former Act at all."

Rule and exceptions.

6. After considering many authorities, the rule of interpretation when there is incorporation by reference, has been summarised along with its exceptions by the

Supreme Court[11] in the following words.

> "Where a subsequent Act incorporates provisions of a previous act then the borrowed provisions become an integral and independent part of the subsequent Act and are totally unaffected by an repeal or amendment in the previous Act. This principle, however, will not apply in the following cases:
> a) Where the subsequent Act and the previous Act are supplemental to each other;
> b) Where the two Acts are in pari materia;
> c) Where the amendment in the previous Act, if not imported into the subsequent Act also, would render the subsequent act wholly unworkable and ineffectual; and
> d) Where the amendment of the previous Act, either expressly or by necessary intendment, applies the said provisions to the subsequent Act."

Any conflict ?

7. There is no conflict between the provisions of Sec.8 (1) of GCA and the above rule of interpretation of, Statutes by reference. What Sec.8 (1) of GCA deals with are statutes, where reference is made to earlier statutes and not where the provisions of earlier statues have been incorporated by reference in the subsequent statute. The rule of interpretation of incorporation by reference laid down by the Courts applies to statutes, which by reference incorporate into themselves the provisions of earlier statutes. These are two different categories of references.

Two categories

8. Legislation by referential incorporation falls under two categories namely, where a statute by specific reference incorporates the provisions of another statute and where a statute incorporates by general reference the law concerning a particular subject as a genus[12]. When law concerning a particular subject has been incorporated as a genus by the subsequent statute, it may be presumed that the legislature intended that subsequent amendments in the referred Act are also adopted in the referring Act. Reference in Sec.151 of the Madhya Pradesh Land Revenue Code 1954 to the expression 'personal law' was held[13] to include the Hindu Succession Act 1956 which was enacted subsequently for determining who are the legal heirs of a tenure holder who died after 1956.

9. When there is reference to an earlier Act without incorporating the provisions of that Act, Sec.8(1) of GCA Applies. When there is incorporation by specific reference, the subsequent amendments made in the referred statute cannot

12. Bajaya vs. Gopikabai (1978) 2 SCC 542 = AIR 1978 SC 793.

13. Ibid.

14. Mahindra and Mahindra Ltd. vs. Union of India & another (1979) 2 SCC 529 = AIR 1979 SC 798. automatically be read into the adopting statute.

Self Contained Act

10. Sec.55 of the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) provided for an appeal on 'one or more of the grounds specified in Sec.100' of the Code of Civil Procedure (CPC). At the time of enacting MRTP Act, there were three grounds for filing a second appeal under sec.100 of CPC. Subsequently, with effect from 1-2-1977, CPC was amended providing for appeal only on substantial questions of law. The question was whether the appeal under the MRTP Act could be filed on any of the three grounds originally provided under Sec.100 of CPC or whether the appeal could be filed

only if a substantial question of law arose in the case. The Supreme Court[14] observed that MRTP Act is a self contained Act and the right to appeal under the said Act could not be made dependent on the subsequent amendments to Sec.100. The Court said that otherwise, if Sec.100 is repealed from CPC, it would lead to a rather absurd and startling result in as much as the appeal provided under Sec.55 of the MRTP Act would not be available at all. The subsequent amendment to Sec.100 of CPC was held not to affect the right of appeal under Sec.55 of MRTP Act.

Diametrically opposite reasoning?

11. In Prevention of Corruption Act, 1947 the term 'public servant' has the same meaning as the meaning contained in Sec.21 of the Indian Penal Code (IPC). The question was whether the twelfth category of public servants added by amendment to Sec.21 of IPC were also public servants for the purposes of Prevention of Corruption Act. It was held that unless it was interpreted as covering the new categories added by the amendment of Sec.21 of IPC, the purpose of the statute would be frustrated and rendered wholly unworkable since both Acts deal with the same subject and in pari materia . The subsequent amendments to Sec.21 of IPC were held[15] to apply to the Prevention of Corruption Act also. 12. A limited reference to the procedure under the Land Acquisition Act (LAA) made in the Punjab Town Improvement Act 1922 was held[16] to refer to the provisions of the LAA as they stood at the time of acquisition and not as they stood at the time of enacting the Punjab Act. It was observed[17] that the acquisition of land was left to be governed by the general law of the land namely Land Acquisition Act. What appears to have weighed with the Court is that the main thrust of the Punjab Act is not land acquisition but Town Planning. Amendments made in LAA after the enactment of Punjab Act were held to be applicable to Punjab Act.

13. In Narasimhan case, subsequent amendments to sec.21 of IPC were applied in PCA as the scope of both Acts was same. In Bhatinda Improvement Trust case, subsequent amendments to LAA were applied to Punjab Act on a diametrically opposite reasoning namely the scope of both Acts is not same. It is therefore difficult to say when subsequent amendments have to be taken into consideration and when not.

Matter of Construction by Courts

14. The question whether a legislation is by way of incorporation or by way of reference is more a matter of construction by the Court keeping in view the language employed by the enactment, the purpose of referring or incorporating provisions of an existing Act and the effect of it on the day to day working[18]. It is a hard job to guess what the legislature intended while making the referential legislation. The test laid down by the Supreme Court in various cases and the provisions of Sec.8 (1) of GCA are quite difficult to apply to specific statutes. It is even possible that the intention of the legislature is not given effect to while interpreting. It is also possible that at the time of enacting, the Legislature did neither intend to make the subsequent amendments applicable nor intend otherwise.

Conclusion

15. This confusion can be sorted out only by the legislature. However, this is not easy. At the time of making the referential legislation itself it may be

15. State of MP vs. M.V. Narsimhan (1975) 2 SCC 377 = AIR 1975 SC 1835.

16. Bhatinda Improvement Trust vs. Balwant Singh & others (1991) 4 SCC 368 = AIR

1992 SC 2214.
17. (1991) 4 SCC 368 at page 373.
18. UP Avas Evam Vikas Parishad vs. Jainul Islam (1998) 2 SCC 467.

made clear in the Act whether the subsequent amendments to the referred legislation should be applicable or not. If the intention is to adopt the subsequent amendments also, immediately after the reference to the provisions of the earlier Act, the words 'as amended from time to time' may be added. If the intention is to apply the former legislation as obtaining at the time of enacting the subsequent legislation, the same may be made clear by using appropriate words, such as, 'as in force at the time of the commencement of this Act'. This would be possible only if the legislature is clear about the scope and effect of both the Acts, more particularly the referring Act.
16. More often than not, it is difficult, rather impossible for the Legislature to forsee what amendments may be made to the referred provision and what effect it could have on the referring Act. In such cases, as soon as an amendment to the provisions of the referred legislation is carried out, the referring legislation should be reviewed and the intention of the legislature, made clear. This again is not an easy task. The task of finding out in how many Acts the amended provisions are referred to, involves a scrutiny of many legislations including State Legislations. It is perhaps this difficulty of the Legislature which forces the litigants to seek in the Court rooms, the hidden intention of the Legislature invoking referential legislation.
17. The referential incorporation is not peculiar only to statutes. It is resorted to, in regulations and other subordinate legislation also. Where the subordinate legislation under one Act has adopted the provisions of some other Act, all the above questions arise before the implementing authority. Instead of the implementing authority venturing to find out the intention of the authority issuing the regulations, by applying the case law, the authority concerned should make known its intention at the earliest. It is therefore, imperative that such subordinate legislation is reviewed at the earliest possible opportunity by the authority issuing such subordinate legislation and if necessary, amendments in the subordinate legislation should be carried out or suitable clarifications, issued. This will help such authorities themselves in implementing their own subordinate legislation.

Central Government's Borrowings under Art. 292- Need for FRBM Bill, 2000

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Sizing the public debt is a prime concern of any developing economy. Excessive Government borrowing raises the rate of interest in the money and capital markets thereby effecting the adverse impact on total investment and partly crowding out private investment. Borrowing today is thus equivalent to taxation tomorrow. Therefore, it is imperative to limit the public borrowing by imposing a statutory cap. A statutory limit on public debt implies a normative level or ratio to which the public debt has to be frozen. Articles 292(Union) and 293(States) of the Constitution of India have expressly left it to the Government to pass a legislation imposing limits on Central Government and State

Government borrowings. Article 292 reads as under;

> The executive powers of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

Since the passing of the enactment is permissive but not mandatory till date the Parliament has not passed any legislation imposing a limit on borrowings. This has kept open the Government arms free for borrowing unlimited quantum of funds to fill the fiscal deficit from time to time monetising the deficits through direct borrowing from the central bank. Shri. Yashwanth Sinha, Finance Minister of India in the last couple of years has undertaken the task of imposing a statutory cap on the Central Government

1. Section 2 (c) of the Fiscal Responsibility Budget Management Bill, 2000.

borrowings from the central bank along with other measures of bringing down the alarming levels of fiscal deficits. For completing this task, the Finance Minister has appointed a Committee on Fiscal Responsibility Legislation (FRL) which submitted its report along with a draft legislation on Fiscal Responsibility. However, the Standing Committee, which has gone through the provisions of the Fiscal Responsibility and Budget Management Bill,2000 has made some recommendations which, if implemented, would water down the spirit of the legislation. Therefore, in the present paper the author has made an analysis of the recommendations of the Standing Committee vis-à-vis the need of having a legislation imposing statutory cap on the central bank borrowings in the light of international experiences.

Fiscal Deficit

The weakness of the fiscal situation in the country has been a matter of concern for more than a decade. Fiscal Deficit means the excess of total disbursements from the Consolidated Fund of India, excluding repayment of debt, over total receipts into the Fund, excluding the debt receipts, during a year. It is thus the excess of total expenditure of the Central Government (including loans but excluding repayment of debt) over its tax and non-tax revenue receipts (including external garants) and non-debt capital receipts during a year and represents the borrowing requirements, net of repayment of debt, of the Central Government during the year[1] . In other words, deficit means the excess of disbursements over total receipts. The fiscal deficit of the Center and States taken together was at around 8.8% in 1998-99. India cannot afford to continue with such high levels of fiscal deficits as it hampers the future growth potential of the economy.[2] In 1997, India ranked tenth of the Central Budgetary deficit as a proportion of GDP, after Greece, Turkey and Pakinstan, among others.[3] Shri. Ashok Upadhyay, famous economist commenting on the levels of deficit in the current financial year has observed that "figures on the fiscal deficit are not too good; with the economy still on the skids, there is likely to be a short-fall in revenue receipts to the extent of around 30 per cent by the time the fiscal year ends; on the expenditure side there have been some savings on non-plan expenditure, barring interest payments, but even if we leave that monster of a debt overhang out for the moment there is little room for any relief on the deficit".[4]

The efforts of the Finance Minister alarming the seriousness of the deficit levels focussing the weakening fiscal situation can be observed from his Budget speech wherein he said that "today, we must squarely confront and overcome the critical challenge posed by a weakening fiscal situation. A long history of high fiscal deficits has left us with a legacy of a huge public debt and an ever growing bill of interest payments… … . If we do not raise the resources and instead take recourse to even higher borrowing next year, then we will jeopardise our prospects for growth, we ignite the flames of inflation, sow the seeds of another balance of payments crisis and place an unfair burden on the next generation".

Further, the Finance Minister, while presenting the Budget for 2000-01, announced (Budget speech, Paragraph 11, Page 5, Part A) as follows:-

> "For medium- term management of the fiscal deficit, we also need the support of a strong institutional mechanism embodied in a Fiscal Responsibility Act. This has been suggested in the Agenda for Governance of the National Democratic Alliance (NDA). I have set up a

2. Crisil Alert, February 2000 Vol. No.6, at p. 1. (www.crisil.com)
3. International Monetary Fund, Government Finance Statistics for Central Budegtary Deficit and the World Economic Outlook for GDP.
4. Business India, December 24, 2001- January 6, 2002, at p. 42.

> Committee to examine the issue and make suitable recommendations. I hope to bring the necessary legislative proposals to the House during the course of the year".

It is in this direction that the Government appointed a Committee under the Chairmanship of Shri. E.A.S. Sarma, Secretary, Department of Economic Affairs (DEA), Government of India and including prominent personalities Shri. Y.V.Reddy, Deputy Governor, RBI, Shri. A.M. Sehgal, Controller General of Accounts, Dr. Ashok Lairi, Director, National Institute of Public Finance & Policy and five other members of repute in economics and law which has submitted the draft Bill on Fiscal Responsibility and Budget Management which was introduced recently. The parliamentary standing committee on finance has made recommendations for its modifications. The Parliamentary Committee has recommended scrapping of most of the key provisions of the Fiscal Responsibility and Budget Management Bill, dealing a blow to the Government's move to undertake fiscal restructuring and consolidation. The clauses which to be the committee wants axed include the one specifying the levels of revenue and fiscal deficit and the time –frame of five years set for it as well as the blanket ban on borrowings by the Government from the RBI, through subscriptions to primary issues by the Government. The committee has argued that these two provisions would hamper the Government's ability to respond to exigencies in an appropriate manner, and also due to fears that higher market borrowings could push up the interest burden when the mandated deficit ceilings are not achieved.

Both provisions are crucial to achieving the goal of long-term macro-economic stability in the viewpoint of the Government and the RBI. The recommendations of the committee, if accepted by the Government, will signal a major watering down of the provisions of the Bill. The Finance Minister, Mr. Yashwant Sinha, however, made it clear that the Government has the option to introduce changes, implying that it is under no compulsion to accept the recommendations of the standing committee in toto.

Central Bank Borrowing- Government's "Safety" Hook

The issue of fixing borrowing limits of the Central Government by Parliament came up for examination on several occasions in the past. When the Estimates Committee (1957-58) on Budgetary Reforms raised this question, Government of India felt that it was not necessary or advisable to introduce any legislation on the subject. Again, the Estimates Committee, 1991-92 of the Tenth Lok Sabha in paragraph 1.192 of the Twelfth Report, however, recommended that a flexible approach in determining a ceiling on borrowing should be adopted. However, the Ministry of Finance stated, inter alia, that Article 292 of the Constitution covers only borrowings on the security of the Consolidated Fund of India i.e., borrowings from market loans, Treasury bills and external loans, which flow into the Consolidated Fund of India and does not cover borrowings like Small Savings, Provident Funds, deposits, etc., which flow into the Public Account of India. The Public Account balances of debt, deposit and remittances are carried forward and not closed annually like the account for budgetary grants under the Consolidated Fund.[5] Though the Committee was disappointed by the approach of the Government, it reiterated the stand that in view of the situation prevailing in the past few years a beginning be made for imposition of statutory ceiling on Centre's borrowing. According to Article 292 of the Constitution of India, Parliament by law may impose limit on its borrowing power. However till date there is no law passed by the Parliament by fixing statutory cap on its borrowings.

The Annual Reports of Reserve Bank of India for 1991-92, 1995-96 and 1996-97 have raised this issue. In the Annual Report of the RBI 1991-92, it has been observed that " to ensure that the monetised deficit does not have deleterious effects on the economy, there is a need for a law restricting the extent to which the Centre can run a deficit and moreover there should e a legal ban on the Government borrowing from all sources beyond a certain ceiling with a sub-ceiling on borrowing from the Reserve Bank of India".[6] Similarly in 1995-96 the RBI has emphatically mentioned that "along with the instituting of a Consolidated Sinking Fund is the need to consider the setting up of a legislative ceiling on public debt".[7]

5. K.Kanagasabapathy, "Placing a Statutory Limit on Public Debt", Reserve Bank of India Bulletin, December 1997.
6. Paragraph 7.20, at p. 91.
7. Paragraph 7.30, at p. 88.
8. Supra note 4 at p. 995.

The major step towards limiting debt financing by Governments has picked up momentum in recent years in view of the Maastricht Treaty singed in 1991 by the European countries. The salient features of the Treaty are,

a) Central bank credit to the government is entirely discretionary, that is, the central bank cannot be forced to provide such credit;

b) Only indirect credit (defined as the acquisition of government securities by the central bank from a third party) is permitted; direct credit (through overdraft facilities, advances or purchases of government paper on the primary market) is prohibited; Indirect credit is unconstrained;

c) National parliaments (or any equivalent political entity at the EC level) have no direct involvement in monetary policy.

According to the Ricardian equivalence theorem, "when public debt increases over time, it shifts the burden of financing this debt from the current generation to the next/future generation, since the government of a country has to cover this debt in future by explicit taxes or implicit taxes (i.e., inflation or seigniorage). Borrowing today is thus equivalent to taxation tomorrow". [8]

In the light of the importance of limiting the public debt especially putting cap on Centre's borrowings from the central bank the Fiscal Responsibility and Budget Management Bill, 2000 has been first tabled in the Lok Sabha in December 2000 at the instance of the Finance Minister, Shri. Yashvanth Sinha. The Government had proposed the reduction of the fiscal deficit by half a per cent annually, which would work out to two per cent of the GDP at the end of the firth year, and also the elimination of the revenue deficit at the end of five years.

The preamble of the Bill expressly mentions that the Central Government borrowings must be limited. It runs " to provide for the responsibility of the Central Government to ensure inter-generational equity in fiscal management and macro-economic stability by progressive elimination of revenue deficit, removal of fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on Central Government borrowings, debt and deficits, greater transparency in fiscal operations of Central Government and conduct of fiscal policy in a medium-term framework and for matters connected therewith or incidental thereto.

Histoty of Government Borrowing from Central Bank

The genesis of Central Government borrowing from the central bank can be traced to the agreements between the Government of India and the RBI, regarding ad hoc Treasury bill, in November 1937 and January 1955. Over time, issuance of such ad hoc Treasury bills became a permanent means of financial support to the Central Government from the RBI. This led to automatic monetisation of Centre's deficit. Large and growing fiscal deficit with a sizeable component of monetised deficit, entailed rapid growth of meoetary liquidity far out of alignment with the real economic growth. This also led to demand and inflationary pressures. The elimination of automatic monetisation of fiscal deficit was considered critical in the stabilisation policy. It was with this objective in view that the Government of India and RBI signed the first Supplementary Agreement in September 1994 to phase out the issue of ad hoc Treasury Bills by the end of the fiscal year 1996-97. Pursuant to this, the issue of ad hoc Treasury Bills was discontinued with effect from April 1, 1997. Keeping in view the fact that there could be temporary mismatches between receipts and payments of the Government of India which would need to be met, a scheme of Ways and Means Advances (WMA) was put in place with effect from April 1, 1997 on the basis of Supplemental Agreement reached on March 26, 1997. As a result there has been a decline in the monetisation of Centre's fiscal deficit. Inflation rate came down from an average of 8.75 per cent during 1980-81 to 1992-93 to 6.57 per cent during 1994-95 to 2000-01.

Summary of Standing Committee's Recommendations

The Standing Committee, headed by Mr. Shivraj Patil, has recommended the following :

1. The Committee has strongly recommended for scraping the numerical ceilings on deficit. The Standing Committee's justification for scrapping the numerical ceilings on deficit and the time-frame is that it would introduce excessive rigidity into decision-making. Thus, the Government would be deprived of the flexibility to respond to exigencies in an appropriate manner and to serve the national interest. Besides, specifying levels of revenue fiscal deficits could lead to a further decline of the already low levels of funds available for developmental purposes.

2. The proposed blanket ban on direct borrowings from the RBI outlined in the Bill has not found favour with the Committee as it reckons that such a ban could lead to higher market borrowings by the Government in the event of any failure to achieve the mandated fiscal deficit reduction targets.

3. The underlying assumptions made by the Government while prescribing the deficit ceilings are not "pragmatic" and hence difficult to attain.

4. Fiscal and revenue deficits should be maintained at a "prudent levels" and these should be defined and incorporated under rules to be prescribed by the Central Government.

5. The Committee's report, which was tabled in the Lok Sabha, has also suggested scrapping a host of other clauses including the amount of guarantees to be given by the Centre and the total liabilities of the Central Government.
6. A strong case has been made out by the committee for building greater flexibility in the clause which provides the Government the leeway to breach the mandated ceilings in the event of a national calamity or a threat to national security by including "those matters which are of utmost public importance".

7. The Committee has recommended deletion of the provisions of the Bill wherein it had sought to restrict guarantees to one and a half per cent of the estimated Gross Domestic Product (GDP) in any financial year. The Bill had also proposed that the total liabilities (including external debt at current exchange rate) at the end of a financial year should not exceed 50 per cent of the GDP for that year.

The other recommendations include modifying the annual Budget to include supplementary, additional or excess demand for grants. The committee has also made it clear that enough safeguards need to build into the proposed Bill to ensure that economic decision-making does not become a subject matter of judicial scrutiny. It also wants a single comprehensive definition on fiscal deficit.[9]

Standing Committee Recommendations —Need to Revisit

It is envisaged in the FRBM Bill, 2000 that under section 5 the Central Government shall not borrow from the RBI, except by way of advances to meet temporary exess of cash disbursement over cash receipts during any fiancial year in accordance with the agreements, which may be entered into by the Government with the RBI. But, the RBI may subscribe to the primary issues of the Central Government securities till the completion of the financial year 2003-2004. The RBI may also buy and sell the Central Government securities in the secondary market. In other words, the participation

9. Business Line, Date 24.11.2001.

by the RBI in the primary market will be dicsontinued in three years but that there would be no restriction on RBI in participating in the secondary market. Accordingly, starting from April 1, 2004, there will not be any monetisation on account of the RBI's subscription to the government securities in the primary issuance market.

It is submitted that the Standing Committee has not gone into the intricacies of issues before they have taken a stand that there should not be nay limit of borrowing from RBI. The Standing Committee has also not considered the observations of the Committee on Fiscal Responsibility Legislation. The Committee on FRL pointing out the advantages of cessation of borrowings from the central bank has said the "the cessation of borrowing by the Government from the RBI in the primary market will provide greater independence to the latter to pursue the monetary policy objectives. Thus, the fiscal policy objectives would not conflict with the monetary policy objectives. Thus, the fiscal policy objectives would not conflict with the monetary policy objectives".

The Committee on FRL emphasised that freeing the RBI from debt management functions, giving discretion to the RBI to independently decide the levels of monetisation and bringing the RBI's credit to Government under strict prudential norms should be pursued as a part of fiscal responsibility.

The magnitude of market borrowings in excess of the absorptive capacity of the market has two fold implication on the stability of the fiscal sector.

First, it puts pressure on the interest rates in the government securities market, which leads to hardening of interest rates in other market segments. A continuous pressure on interest rates has adverse implications fro the banking sector's investment portfolio and its profitability, apart from acting as a uncertainty regarding the future interest rates, giving rise to adverse inflation expectations. Second, high levels of domestic debt and interest rates challenging in the area of management of capital flows in the context of the liberalization in capital account. While it provides incentive for inflow of short-term capital into the economy, the need to maintain these flows and carry out sterlisation operations in the money market may require raising the interest rates to unsustainable levels. This could act as a deterrent in progress towards further liberalisation of external sector and achieving higher intergration between the domestic and international financial markets.

International Experience

An over view of international experiences crystallizes that most of the countries adopted legislations setting limits on Central Bank credit to Governments. In fact few countries have imposed restrictions on Government borrowings by passing a legislation viz. the Deficit Reductional Debt Country Act in Canada, Goria Plan in Italy, Medium-term Financial Strategy in U.K., Balanced Budget and Emergency Deficit control Act, Gramm Rudman Hollings Act in U.S.A. (1985), Fiscal Responsibility Act of New Zealand (1994), Budget Honesty Act, 1998 of Australia and Fiscal Responsibility Law, Argentina, 1999. On a careful study of the Fiscal Policy Rules (a study done by International Monetary Fund, 1998), it may be observed that the following countries have imposed restrictions under legislation on Government borrowings, viz. Indonesia, European Union Members, Argentina, Canada, Chile, Hungary, Japan,Peru, United States. These countries restricts borrowing from Central Bank except in case of Indonesia where there is a restriction on domestic borrowing (since 1967).

In case of CFA Franc Zone Members the borrowings from Central Banks are limited to 20% of last year's revenue.

In case of Brazil, Egypt, Morocco, Philippines and Slovak Republic the borrowings from Central Bank limited as fixed proportion of last year's revenue.

George Kopits, observed

> "Besides consisting of restrictions on the overall budget balance, government borrowing, or public debt (as envisaged under Economic and Monetary Union (EMU) for example), fiscal rules may encompass key subsets of these aggregates, including the current budget balance – that is, permitting borrowing only for investment (as applied with regard to subnational governments in Germany and the United States). Also, in the absence of sufficiently developed domestic financial markets or given limited access to external sources of financing, prohibition on domestic borrowing (as in Indonesia) and restrictions on borrowing from the central bank (as in CFA Franc Zone member countries) may impose a severe constraint on the budget deficit and thus serve as fiscal rules". (emphasis is supplied). IMF Paper 1998 at p.2

The following table evidences the legislations passed by some of the countries providing limitations on fiscal borrowing from the central banks (IMF Occasional Papers 1998).

Name of the country	Name of the Legislation	Restriction
Argentina Modified in December 2000	Fiscal Responsibility Law, 1999 requires that it should decline so that	Imposes a ceiling for the deficit and balance is achieved in 2005.
Brazil	Fiscal Responsibility Law, 2000 fixed proportion of last year's revenue.	Borrowings from central bank limited as
		Prohibits financial support operations among different levels of Government. Sets measures to improve transparency and accountability.
Peru	Fiscal Transparency Law, 1999	No borrowing from central bank.

Japan	The Fiscal Structural Law,1997	No borrowings from central bank
Canada	Name of the Act not known.	No borrowings from central bank
Indonesia	Fiscal rule is contained in guidelines for State Policy	No domestic borrowing since 1967
Netherlands	Policy Norm 1961	The structural deficit ceiling was introduced.
Kenya	Central Bank of Kenya Act, 1966 amended by the Amendment Act, 1997	The scope of the Government to get direct advances from the central bank has been considerably narrowed down.
United Kingdom	Code for Fiscal Stability (1998)	The “golden rule” stipulates that borrowings should be used only to finance investment.
Sweden	State Budget Act, 1996	Imposes a ceiling for total Central Government expenditure
CFA Franc Zone Members	Since 1973	Borrowings from central bank limited to 20% of last year’s revenue
United States of America	Balanced Budget and Emergency Deficit Control Act (Gramm-Rudman-Hollings Legislation) 1985 Budget Enforcement Act,1990 Omnibus Budget Reconciliation Act,1993 Omnibus Budget of 2000.	Imposed an annual deficit reduction for a five year period with a balanced budget (or zero deficit) No borrowings from central bank.
New Zealand	Fiscal Responsibility Act,1994 fiscal management.	To promote consistent and good quality Strengthens accountability.
Australia	Chartered for Budget Honesty Act, 1998	Provides institutional framework for the conduct of Government Fiscal Policy Rules in Australia

Conclusion

In the light of the above discussion, it is evident that even the developing countries have passed legislations imposing statutory cap on the power of the Central Government to borrow from their central banks on par with the advanced countries like USA etc. After having run the country for the last five decades without a fixed limit on borrowings of the Government, it is the need of the hour that the Parliament should pass the FRBM Bill ignoring the Standing Committee recommendations. The argument of the Standing Committee that ‘imposing limit on Central Government borrowing from the central bank would hamper the Government’s ability to respond to exigencies in an appropriate manner, and also that higher market borrowings could push up the interest burden when the mandated deficit ceilings are not achieved’ is incorrect and in fact it is other way round. That is, in our opinion, imposing the statutory limit would put the Central Government to limit its public spending. However, the option to raise the revenue by resorting to taxation is still open to the Government. It is submitted that the Standing Committee’s recommendations sound logical but fail to meet the needs and requirements of the country. Further, prescribing statutory cap on borrowings and restraining the Central Government borrowings from the central bank would facilitate the central bank to reach the objectives set out under monetary policy.

It may be concluded that there is a growing concern the world over, particularly during the last decade, to provide limitations on the Government’s borrowings especially from their central banks. Taking note of the international experiences and since the economy is in a tailspin, the Financial Responsibility and Budget Management Bill, 2000 should be passed in toto without changing the draft provisions as recommended by Committee on FRL which promises the people a growth-oriented budget towards a sound governance.

MLM - Multi Level Marketing or Money Lures Money : A Tragedy at Multi Levels

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(The author is trying to look at the law relating to money circulation from a social angle. It is interesting for an academic to see how people commit crimes without knowing it. These are some scenes bloated out of real life that are enacted and re-enacted at different occasions and parties all over the country.)

Scene I

It is a New Year party for the staff members of a reputed organisation. The atmosphere is one of joy and relaxation. Prasad, our protagonist, a father of two children is quietly seated in a corner observing the gathering. He starts thinking about the bills to be paid in the month. His friend Supriya walks in seeing him palpably perplexed.

Supriya : What has happened to you?

Prasad : I was just pondering over the soaring cost of living in the megalopolis. Last year has been a disaster, financially. I should have stuck to the DISC model. Supriya : (unable to comprehend the abbreviation and mistaking it for a model recommended by some Working Group on investments): Sorry, I am not aware of many of the recommendations of the various new committees and working groups.

Prasad : Dear me! DISC is not a recommendation. It is the short for Double Income Single Child, where both the spouses work and have only one child.

Meanwhile, Alex, who has been eavesdropping on the conversation, joins them.

Alex : The year has been really great for me.

I have bought a house and changed my car. It is all because of my wife's membership in a multilevel marketing arrangement. She has hundreds of agents working under her.

Prasad : I have also heard about these new money making agencies but have been sceptical about investing in them.

Alex : There is nothing to fear. Even if you work for once and then do not work at all you are assured of getting back your initial investment. The business plan is contained in the brochures and booklets supplied by the company. I will give a brief description of the way in which our scheme works. Any one of our product distributors enrols you into the scheme.

You have to buy a product of your choice from the options available in the brochure given to you by the company. Then you will become a product distributor. Look at this brochure. A list of products is given. Cosmetics, toothpastes, Washing powder, sunglasses and many other items.

Prasad : How can I pay such high prices for the cosmetics and other products to join your scheme? I have not even heard about the quality of these products. Moreover, I'm already broke.
Alex : Who cares for the cosmetics and toothpastes? Look at the money you will make by joining the scheme. Consider the high price you pay for the products as an investment for making huge sums of money. In the first stage you may enrol two product distributors and get a commission of Rs.500/- for each enrolment. When you enrol your third product distributor you are promoted to the rank of a direct product distributor.
From then onwards you will get Rs.1250/ - as commission for every enrolment.

Prasad : I do not have the contacts to make so many people buy the products. What will happen if I am not able to sell the products?

Alex : You just have to enrol three or four people and then lay back and relax! When the third product distributor of yours enrols his first two product distributors, you will get an amount of Rs.750/- for each enrolment. When the third product distributor of yours enrols his third distributor he will move out of the your network leaving his first two product distributors to work for you. You would be getting a commission of Rs.750/- for every enrolment done by the members of your network. As you can see from our company's brochure, even if you enrol only three distributors your yearly income will be a staggering Rs.30,71,750/-. If you enrol more product distributors, you will get this amount from each enrolment. The income payable to the agents depends on the number of new agents introduced in the network. The agents once enrolled in the scheme need not sell or market any product to earn income after the first level.
Prasad : Why will some other person work for my gain? What if he does not enrol more members and sell products after enrolling himself?

Alex : There lies the crux! A person has to enrol more members and sell the products for recovering the money initially invested by him on the products.
Since every new member has to enrol more members to recover his money the chain will go on to multilevels and you will go on pocketing your commission. Then again you can become a product distributor or direct product distributor after you reach the 10th level as mentioned in the brochure. There you will be getting a fixed sum running into crores. So cheer up and be ready to become a millionaire. If you want I will introduce you to a product distributor.

Prasad : Let me think it over and I will let you know if I want to join.

Scene II

Our protagonist is seen visibly excited and is talking seriously with his friend Feroz.

Feroz : Are you mad! Millionaire! You will end up in Prison!

Prasad : But he said it is just about marketing some cosmetics and other household things and moreover I am just running an agency. Why should I go to jail for marketing something?

Feroz : These kinds of schemes are nothing but camouflaged 'money circulation schemes'. Money Circulation Schemes are also known as ponzi schemes in the US of America, named after the first man who introduced it to make money and are called pyramid schemes in other countries. Countries like Australia, U.K. and China are contemplating a ban on such multilevel marketing schemes.

In the Internet you can find lots of websites campaigning against multilevel marketing. These sites have been started by people who have lost their hard earned money in such schemes. Thank God! In India, money circulation schemes are banned under the Prize Chits and Money Circulation Schemes (Banning) Act, 1978. Section 2 (c) of the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 defines a money circulation scheme as, any scheme, by whatever name called, for the making of quick or easy money, or for the receipt of any money or valuable thing as the consideration for a promise to pay money, on any event or contingency relative or applicable to the enrolment of members into the scheme, whether or not such money or thing is derived from the entrance money of the members of such scheme or periodical subscriptions.

Prasad : Do you mean to say that making of quick or easy money is an offence? Then our lawyers in the higher Courts who charge astronomical amounts for one appearance and doctors who collect a fortune for one operation will all be put in jail.

Feroz : The Supreme Court had examined this question in State of West Bengal Vs Swapan Kumar AIR 1982 SC 949 while discussing the definition of 'money circulation scheme' and has rearranged the definition for the sake of clarity as: "any scheme, (a) for the making of quick or easy money or (b) for the receipt of any money or valuable thing as the consideration for a promise to pay money, on any event or contingency relative or applicable to the enrolment of members into the scheme, whether or not such money or thing is derived from the entrance money of the members of such scheme or periodical subscriptions." The court has clearly explained the ingredients, which need to be fulfilled for a scheme to become a money circulation scheme. Any scheme for the making of quick or easy money contingent upon the enrolment of members into the scheme is a money circulation scheme. Similarly, any scheme in which money or any valuable thing is received and a promise is made to return the money on the event of enrolling members into the scheme is also a money circulation scheme.

Prasad : But such a law will be contrary to the freedom to carry on any occupation, trade or business as enshrined in Article 19 (1) (g) of the Constitution of India.

Feroz : The constitutionality of the provision has already been examined and upheld by the Apex Court in Srinivasa Enterprises Vs Union of India AIR 1981 504 SC. Justice Krisna Iyer in his usual flair for writing unforgettable quotes wrote : "Can you save moths from the fire except by putting out the fatal glow?".

The Supreme Court has further stated that these types of schemes are prejudicial to the public interest and also adversely affect the efficacy of fiscal and monetary policy. While interpreting the definition of money circulation scheme, one has to look at the mischief which the legislation has sought to remedy. The legislation was proposed by the James Raj Committee constituted by the Reserve Bank of India in the year 1974. After studying the various schemes which were floated in the country during that time and taking into consideration the impact of such schemes on the economy, the Committee after extensive research and analysis have suggested for a ban on Prize chit and other schemes which were causing a great loss to the economy. A large amount of money that can be used for industrial and developmental activities are wasted on such illegal schemes.

Prasad : I have seen a couple of prize chits schemes and money circulation schemes promoted by some charitable institutions. They have been going on smoothly without any problem.

Feroz : Look, I did not say that all money circulation schemes are illegal. Money circulation schemes conducted or promoted by certain categories like the State Governments or a company wholly owned by it, the Central Government, a banking company as defined in clause (c) of Section 5 of Banking Regulation Act, 1949, State Bank of India or its subsidiary, any charitable or educational institution notified in this behalf by the State Government, in consultation with the Reserve Bank of India etc. have been exempted from the provisions of the Act under Section 11. In the Sreenivasa Enterprises case it was even argued that such an exemption is violative of Article 14 (equality before law and equal protection of the laws) of the Constitution. The Supreme Court did not agree with the argument and opined that all the exempted categories are under public control and there are enough arguments to justify the different classifications.

Prasad : Which agency is entrusted with the powers to take action against such illegal activities?

Feroz : All the offences under the Act are Cognisable. Under Section 7 of the Act, a police officer not below the rank of an officer in charge of a police station can enter, if necessary by force, by day or night, any premises which he has reason to suspect, are being used for purposes of conducting or promoting any money circulation scheme. He can search such premises and take into custody any person and produce before a Judicial Magistrate all such persons who have been concerned with the use of such premises connected with the promotion or conduct of any money circulation scheme. He can seize all things found in the premises which are intended to be used, or reasonable suspected to have been used, in connection with any money circulation scheme. Under Section 8 of the Act the State Government can forfeit any newspaper or publication containing any material connected wit the promotion or conduct of money circulation scheme.

Prasad : I agree with you that money circulation schemes are banned under the Prize Chits and Money Circulation Schemes (Banning) Act, 1978, but in the scheme of the company we are discussing there is a sale taking place with every enrolment. So I think it is a genuine commercial transaction and not money circulation.

Feroz : For considering whether a scheme is a money circulation scheme or not, we must analyse the scheme as a whole. In the present scheme, a person is lured into the scheme and made to buy some products by promising him that he will be getting huge amounts of money in return. Moreover, the money he gets in return is linked to the number of persons he or his agents enrol rather than the number of independent sale of the product. Sometimes, a person is forced to buy products at exorbitant rates, which are many times higher than market rates of similar competing products on the promise that he will be getting huge returns. Then he is left with no option but to enrol more members into the scheme and recover the money already paid to the company, as an exorbitant price to the product, in the guise of commission. The thrust of the brochures and business plans issued by such companies will be on making money by enrolling more members and not on the sale of products. It is thus clear that the plan uses the lure for money as the bait to attract people into the plan and the sale of products is of secondary or no importance at all.

Prasad : It is really a camouflage. But why any person will go to jail for enrolling as a member and that too when he is not the promoter?

Feroz : Under Section 3 of the said Act, no person shall promote or conduct any money circulation scheme, or enrol as a member to any such scheme, or participate in it otherwise, or receive or remit any money in pursuance of such scheme. So even a person enrolling himself as a member or participating in the scheme is an offender. The prescribed punishment under Section 4 is imprisonment for a term which may extend to three years, or with fine which may extend to five thousand rupees, or with both. A minimum punishment to the extend of imprisonment of not less than one year and fine not less than one thousand rupees have been provided. This shows the gravity of the offence. Then again printing, publishing, selling or distributing any materials relating to such schemes have been made punishable with imprisonment for term which may extend to two years, or with fine which may extend to three thousand rupees, or with both, under Section 5 of the said Act. Here also a minimum punishment to the tune of imprisonment not less than one year and/or fine not less than one thousand rupees have been provided. Still do you want to join the scheme?

Prasad : No. Thank you for saving my life! But for you, I would have gone to jail. How nice, the New Year has begun with enlightenment and a new resolution. I will build my world with hard earned money and not easy money. Happy New Year to You!