

Chapter – 7

LEGAL FRAMEWORK FOR ELECTRONIC BANKING

7.1 Introduction

7.1.1 Legal issues relating to electronic transaction processing at banks are very many and the need to address them by amending some of the existing Acts and by promoting legislation in a few hitherto unexpected areas has assumed critical urgency. Necessary legislative support is essential to protect the interests as much of the customers as of the banks / branches in several areas relating to electronic banking and payment systems. This is specially required to establish the credibility of ECS and EFT schemes based on the electronic message transfer. Since the Reserve Bank is embarking on large electronic schemes such as the nation wide RTGS, it is time that efforts are made to bring about necessary legislative framework that synchronises and synthesises with the initiatives taken by the Government of India, Department of Electronics for promotion of the Information Technology Bill, 1999 and / or the Electronic Commerce Bill, 1999.

7.2 Electronic Funds Transfer Act

7.2.1 In 1995, the Reserve Bank had set up the Committee for Proposing Legislation on Electronic Funds Transfer and other Electronic Payments (Chairperson : Smt. K.S.Shere). The Shere Committee had recommended a set of EFT Regulations by the Reserve Bank under the Reserve Bank of India Act, 1934 and amendment to the Bankers' Books Evidence Act, 1881 as short term measures and promotion of a few Acts like the Electronic Funds Transfer Act, the Computer Misuse and Data Protection Act etc. as long term measures. The Reserve Bank has already initiated steps for framing of EFT Regulations. The Government of India have also initiated steps for promoting Information and Technology Act, 1999 and consequential amendments to the Reserve Bank of India Act, 1934, the Bankers' Books Evidence Act, 1881 etc.

7.2.2 The proposed Information Technology Bill, 1999 and Electronic Commerce Bill, 1999 are intended to be general purpose legislation covering mainly issues like secure electronic records and signatures, acceptance of digital signatures, duties of certification authority, liability of network service providers, computer crime and data protection. Both the bills deal with electronic contracts and they are being promoted by the Government of India primarily to facilitate introduction of Electronic Data Interchange in the commercial sector. However, they are equally applicable for electronic funds transfer already launched by the Reserve Bank and is going to be increasingly resorted to by the user banks of the VSAT based network, the INFINET. However, there is still a need for a separate Act for Electronic Funds Transfer because certain transactional issues like payments finality, rights and obligations of the parties involved in electronic funds transfer etc. cannot be covered in general purpose bills like the proposed Information Technology Bill or the proposed Electronic Commerce Bill. The EFT Regulations being framed by the Reserve Bank would address only the specific type of EFT system that the Reserve Bank would be involved with as a service provider as also a regulator. The EFT

Regulations would, moreover, cover only credit transfer related transactions and not Debit Clearing transactions. A separate legislation on the lines of Electronic Funds Transfer Act of USA is, therefore, required which would be consumer protection oriented and would at the same time address transactional issues like execution of payment order, settlement finality, etc.

7.2.3 The Reserve Bank has taken the help of a consultant in drafting a new legislation on Electronic Funds Transfer System and proposing amendment to the Reserve Bank of India Act 1934. The Committee, after a careful examination of the issue, has endorsed the view that the proposed Electronic Funds Transfer Act should cover all forms of electronic payments. The Committee supports the view that the Reserve Bank, at an appropriate time, consider operating the inter-bank payment systems through an agency or subsidiary so that its regulatory role is rendered distinct from its supervisory role. Retail payment systems such as the ECS and the EFT Remittance Processing Scheme presently operational may be managed by a group of large banks with country wide branch network and technical capability, with settlement assistance from the Reserve Bank. This would help the RBI to focus its efforts only on large value time critical funds transfers to be settled on an RTGS basis. In the ongoing debate on the role of central bank in payment systems, the trend is towards distinguishing the central bank role as a regulator from that of service providers which could be commercial banks themselves or the entities under the control of commercial banks. The Committee has considered it necessary that the legal framework for payment system takes into account this international trend.

7.3 Encryption of messages transmitted over PSTN lines:

7.3.1 The Committee understands that at present banks in both the public and private sectors use a code book for purposes of coding and decoding TT messages. For transmitting messages involving transfer of huge sums, the sending branch codifies the message and the receiving branch decodes the message after its receipt with the help of the cipher code book. Though the public telephone / wireless network is used, the code is adopted only for inter-branch transfers of the same bank. However, if the messages of funds transfer are to be electronically transmitted to different bank branches all over the country, it is necessary that a common code for encryption is used and adopted for all banks involved in inter-bank transactions. The Committee has examined this aspect in greater detail in Chapter 5 of this Report and recommended that all financial messages should necessarily be encrypted.

7.3.2 The Committee is aware that as per the existing policy of DoT, the use of PSTN lines for connecting with other private network is prohibited unless specific exemption is given by DoT. The Committee strongly recommends the use of PSTN lines between branches and the INFINET network for its optimum use. It is, therefore, necessary that banks are permitted to encrypt the messages on the PSTN lines as well. Permission to use PSTN network for connectivity to INFINET should coincide with the permission to encrypt the messages as well.

7.3.3 As regards possible delay on account of use of PSTN lines, it may be necessary to free the service provider from any liability on account of delay, since efficiency of the public telephone network cannot be assured by the service providers.

7.4 Admission of electronic files as evidence and preservation of records:

7.4.1 The Shere Committee had discussed the issues of admitting electronic files as evidence and of preserving electronic records and recommended the need to amend the Bankers' Books Evidence Act, 1881 on the lines of the Customs and Central Excise Laws (Amendment) Act, 1988 and Central Excise and Salt Act, 1944 for the purpose. It is learnt that Government of India is processing the draft Bill amending the Bankers' Books Evidence Act, 1881. This is a welcome development and would meet the legal requirement of acceptance of contracts, documents etc. in electronic form as evidence.

7.4.2 The Committee considered certain provisions of the proposed Electronic Commerce Bill for admitting electronic records / signatures as evidence. Clauses 9, 10, 11, 12 and 14 of this proposed Bill which are relevant in this connection are given in **Annexure 16**. It is worth mentioning that while clauses 9, 10 and 11 of this Bill are based on the UNCITRAL Model Law, clauses 12 and 14 are based on Singapore Electronic Transactions Act. As and when the Electronic Commerce Bill is passed, these provisions will be made applicable, *ipso facto*, to electronic funds transfer transactions as well.

7.5 Funds Transfer through EFT Systems from Tax Compliance Angle

7.5.1 The Shere Committee had recommended that the Central Board of Direct Taxes (CBDT) may be requested to take up the question of clarifying and, if required, amending the relative provisions of the Direct Tax Laws like Section 40A of the Income-Tax Act, 1961. The Committee however felt that, for according the funds transfer under the EFT system the same status of payment as one made by an A/c payee cheque, suitable technology may have to be developed for treating such transfers as A/c payee transfers. A mere recognition to that effect by the CBDT may not be adequate to treat such transfer as A/c payee cheques. Legal provisions need to be made if such recognition has to be given. The first test would arise when paper instruments like cheques are used along with the use of EFT system. So long as both the systems are in existence at the same time, it would require either amendments to the Negotiable Instruments Act or a separate legislation to deal with the matter.

7.6 Cheque Truncation

7.6.1 Cheque Truncation is a method of payment processing whereunder movement of the paper instrument is truncated by substituting with electronic transmission of the cheque details or data. The Shere Committee had examined the legal issues pertaining to cheque truncation and had indicated that the definition of *presentment* in the Negotiable Instruments Act may have to be amended for adoption of cheque truncation system in India. Under the Negotiable Instruments Act, 1881, cheques would have to be presented

for payment to drawee / drawer bank. Without such presentment, no cause of action arises against the drawer. In default of presentment of a cheque to the drawee for payment, other parties to the cheque are not liable to the holder. It is by banking practice and under the Uniform Rules and Regulations for Clearing Houses that banks have agreed for presentment at any place other than the branch, such as the clearing house. Besides, the implications of the definition of *payment in due course* under the Negotiable Instruments Act, 1881 may make it difficult for banks to introduce cheque truncation system simply by agreement among themselves. The right of the paying bank to require physical presentation and possession of the cheque are designed to provide the bank with an opportunity to examine the signature and other authentication of the cheque. This is meant essentially to protect the interest of the drawer. Therefore, in UK, the cheque truncation system started with *customer consent agreements* and was eventually introduced after a fair degree of familiarisation with imaging technology by the banks. Thus, introduction of cheque truncation system may require adoption of a fairly standardised imaging technology and appropriate amendments to the Negotiable Instruments Act, 1881.

7.7 Need for Regulation / Legislation on Netting

7.7.1 There is a growing debate on the legality of *netting* in inter-bank funds transfer transactions. This is more so in the case of large value transactions. The position gets all the more complicated in the case of cross border netting arrangements. In fact, the issue gained critical significance while examining the proposal for setting up of a foreign exchange clearing and settlement system in India. The basic issue in netting systems is that of the settlement risk and the systemic risks borne by the participants if one or some of the participants fail to meet the clearing liability. In case of funds transfers settled on a *gross* basis, the parties involved are only two and *principal risk* if any, is only for the specific transaction. But in multilateral netting systems where claims and obligations accumulate over a period of time (called the clearing cycle), incoming and outgoing payments are set off against each other. In case of failure of a party in meeting the clearing liability, the methodology of identifying the counter-parties / counterparts and determining the exposure level becomes difficult. Although netting system is in vogue in India for all inter-bank clearings by way of procedural details embodied in the Uniform Rules and Regulations for Clearing Houses, it is necessary that the provisions are made statutory. There is a need to amend Section 58 of the Reserve Bank of India Act, 1934 with a view to enabling RBI to frame specific regulations relating to netting practices and domestic payments and settlement systems.

7.8 Recommendations

7.8.1 The Reserve Bank of India Act, 1934 needs to be amended with a view to providing RBI with the desired regulatory and supervisory powers on payment and settlement systems. Simultaneously there is also a need to formulate a separate legislation on electronic fund transfer system. This will *inter alia* facilitate multiple payment system by banks and financial institutions.

7.8.2 The RBI and IBA should pursue with the Department of Telecommunications (DoT) / other competent Authority to permit encryption of data files / messages transmitted through communication channels. This would facilitate easier access to remotely located branches to the INFINET network. The standardised financial messages would also get necessarily encrypted irrespective of the type of network used - private or public.

7.8.3 As recommended by the Committee for Proposing Legislation on Electronic Funds Transfer and other Electronic Payments, amendments to the Bankers' Books Evidence Act, 1881 and other relevant Acts would need to be carried out. This would facilitate recognising computer print-outs and records stored on electronic media used in banking transactions as primary evidence within the definition of the Bankers' Books Evidence Act, 1881.

7.8.4 The provisions made in the proposed Electronic Commerce Bill, 1999 and the Information and Technology Bill, 1999 seek to clarify the legal position on several issues in electronic transactions which would equally apply to banking transactions carried out on computer and communications networks. To firm up the responses of banking industry to the initiatives taken by the Government of India and for bringing about a new legislation on electronic funds transfer as also to examine legal issues that arise in the course of development of electronic banking, a Standing Committee to examine all legal issues on Electronic Banking with members drawn from the Legal Departments of the RBI, IBA, a few banks and Department of Electronics may be set up by the Reserve Bank.

7.8.5 CBDT would need to take up the question of amending the relative provisions of the Direct Tax Laws like Section 40 A of the Income Tax Act, 1961 to accord electronic funds transfer the status of crossed cheques / drafts for the purpose of payment of income tax and other taxes. Simultaneously, it should be ensured that the account payee transactions are put through the electronic fund messages to the stipulated account in the same manner as account payee crossed cheques are treated.

7.8.6 To facilitate the introduction of cheque truncation in India, the definition of *presentment* in the Negotiable Instruments Act, 1881 would have to be amended to permit electronic presentment of data or image of the cheque. The Reserve Bank may be empowered to frame Regulations on Cheque Truncation by suitable amendment to the Reserve Bank of India Act, 1934. Appropriate changes may accordingly be incorporated in the Clearing House Regulations and Rules as well.

7.8.7 As already recommended by the Shere Committee, there should be a clear distinction between the role of a service provider and that of a regulator and supervisor. Since low value and high volume payments require a good deal of servicing of the participating institutions, it is recommended that such payment and settlement systems may be managed by a group of banks with only the net clearing positions being settled at the Reserve Bank or the settlement bank as notified by the RBI. The Reserve Bank may restrict its electronic funds transfer services only for large value transactions and essential

Government securities transactions. Suitable amendment may be carried out to the Reserve Bank of India Act, 1934 empowering the RBI to frame regulations on operating its own electronic funds transfer services as an extension of the Remittance Facilities Scheme, 1940 and to implement model regulations for electronic funds transfer, payment and settlement systems to be operated by group of banks.

7.8.8 The proposed Standing Committee on legal issues on Electronic Banking may, among others, consider the need for appropriate regulation/ legislation on netting of inter-bank payment obligations arising out of the EFT systems which would operate on deferred/ discrete/ netting basis. The need for a model Posting Rules which would determine the time of posting of the net position and time gap after which withdrawal would be permitted by the bank acting as the Settlement Bank, may form part of the netting regulations/ legislation. The Standing Committee may examine the need for incorporating for model risk management practices as part of the netting regulation / legislation.

7.8.9 The issue of confidentiality and sharing of data among the users need to be examined in view of the banks secrecy obligations. The Standing Committee may also examine the legal aspects which would enable sharing of confidential data between the user agencies.