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B.B.A. BANKING

SECOND YEAR

PAPER - V : PRACTICE OF COMMERCIAL BANKING

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UNIT – II	TYPES OF SECURITIES FOR GRANTING LOANS
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Unit – I

Lending of money by banks; Principles of sound lending – Forms of advances such as cash credit, Overdraft, Loan, Purchase and Discounting of bills – Borrowers study.

Unit – II

Secured advances; Different types of securities viz., Government securities, Corporate securities, Life Insurance Policies, Goods, Document of Title to Goods, Real Estate and Book debts. Model of creating charging viz. Lien, Pledge, Hypothecation and Mortgage.

Unit – III

Guarantees : Definition - Essential features of a contract of guarantee – Liability of the study – Rights of surety – Obligations of creditor towards surety – Rights of creditor.

Unit – IV

Loan appraisal: Managerial appraisal, Technical appraisal, Commercial appraisal and financial appraisal – Follow up and supervision – NPAs.

Unit – V

Documentation: Meaning – Documentation in respect of various types of borrowers and securities – Essential clauses – Indian Stamp Act – Limitation Act.

BOOKS RECOMMEND:

1. Bedi H.L. and Hardikar V.K. - Practical Banking Advance
2. Tannan M.L. - Banking Law and Practice in India, Thacker & Co.
3. IIB - Commercial Banking 4 Volumes

PREFACE

Indian financial system has been undergoing a tremendous transformation in recent years. Finance is the life blood to all type of business concerns. Commercial banks are playing an important role for the economic development of our country by providing various type of loans and advances.

This books brings out the information pertaining to financial services rendering by the Modern Commercial Banks. I hope that this book will be more useful to the student community.

R. Chandrasekaran

UNIT – I

ORIGIN OF BANKING

The word 'Bank' is derived from the words "Banco", "Bancus" or "Bangue", all of which mean a bench. The early bankers transacted their money-lending activities on benches in the market place. It was on these benches that the medieval European money-lender and money changers used to exhibit Coins of different Countries, of different denominations for the purpose of changing and lending money. According to some other writers, the word "Bank" is originally derived from the German word "Back" meaning a joint a stock fund. Anyhow, whatever be the origin of the work, this has been in use from the middle ages in connection with the business of money lending.

According to Banking Regulation ACT, 1949, Sec 5(b), the term "Banking" is defined as "accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and with draw able by cheque, draft, and order or otherwise".

LENDING OF MONEY BY BANKS:

Lending of funds to the constituents, mainly traders, Business and industrial enterprises, constitutes the main business of a banking company. The major portion of a bank's funds is employed by way of loans and advances, which is the most profitable employment of its funds. The major part of bank's income is earned from interest and discount on the funds so lent. The business of lending nevertheless, is not without certain inherent risks. While lending his funds, a banker follows a very cautious Policy and Conducts his business on the basis of the well known Principles of sound lending in order to minimize the risks.

PRINCIPLES OF SOUND LENDING

1. SAFETY

Whenever a banker lends money, he must carefully consider the chances of its being repaid by the borrower, along with interest. The repayment of the loan depends upon the borrower's (a) Capacity to pay, and (b) willingness to Pay. Capacity to pay is determined by the financial soundness of the borrower, and willingness to Pay depends upon a Person's honesty and integrity. A thorough inspection of the Profit and loss account and the balance sheet of the borrower, regarding his financial State of affairs should be made to ascertain his capacity. Willingness to pay on the other hand depends, up on a person's character, past dealings, or an enquiry from the references, can be good sources to determine the borrower's character, i.e his honesty and integrity.

2. LIQUIDITY

Bankers are essentially intermediary for short team funds. Therefore, they lend funds for short periods and mainly for working Capital purposes. Therefore, the loans are largely payable on demand. The banker must ensure that the borrower is able to repay the loan on demand or within a short period. Liquidity depends upon the type of faculties received against the advance. For example goods and Commodities are easily marketable while fixed assets like land and building and plant and equipments can be liquidated after a time interval. Thus, the banker regards liquidity as important as safety of the funds and grants loans on the security of assets which are easily marketable without much less.

3. PROFITABILITY

Commercial banks are Profit cunding institutions. They must employ their funds profitably so as to earn sufficient income out of which to pay interest to the depositors, salaries to the staff and to meet various other establishment expenses and distribute dividends to the shareholders. Interest on deposits is governed by the Reserve Bank of India directives, issued from time to time. The rate of inertest changed from customers depends upon the purpose for the advance and the degree of risk involved in lending to them. Greater the amount of risk involved higher will be the rate of interest charged.

4. DIVERSIFICATAION OF RISKS

The Principle of diversification is based on the famous maxim. "do not keep all the eggs in one basket". As there is risk in every advance, banks should spread the risk by lending to a large number of borrowers, instead of giving the advances to a few by making large advances should not be concentrated in few big firms or few industries rather should be spread amongst a number of firms, in different industries and in different cities.

5. PURPOSE OF LOAN:

While lending his funds, the banker enquires of the borrower the purpose for which he seeks the loan. Banks do not grant loans for each and every purpose. For the Safety of the funds, it is necessary that funds be lent for productive purposes only. Loans are not advanced for speculative and unproductive purposes like social functions and ceremonies or for pleasure trips or for the repayment of a prior loan. After the nationalisation of major banks, loans for initial expenditure to start small trades, business industries etc are also given by the banks.

FORMS OF ADVANCES

Depending on the requirements of the borrowers, advances by commercial banks take the form of loans, cash credits, overdrafts, bills discounted etc. These are usually short term advances and are generally utilized to meet the working capital requirement of the borrower. The following are the main styles of credit or systems of financing prevalent in our country.

1. LOAN SYSTEM

Under the loan system credit is given for a definite purpose and for a pre-determined period. Normally, these loans are repayable in installments. Funds are required for single non repetitive transactions and are withdrawn only once. If the borrower needs funds again or wants renewal of an existing loan, a fresh request is made to the bank. Thus a borrower is required to negotiate every time he is taking a new loan or renewing an existing loan. Banker is at liberty to grant or refuse such a request depending upon his own cash resources and the credit policy of the central bank.

Loan may be allowed against the personal security of the borrower, but usually and particularly where amount is heavy tangible security in the form of Government securities, shares debentures, fixed deposit receipts, life insurance policy, documents of titles to goods etc, is taken.

2. OVER DRAFTS

Over draft is usually a temporary arrangement and is granted to the customers having currant accounts. It represents permission to overdraw a current account up to a sanctioned limit unlike loans, withdrawals on deposits can be made any number of times provided total amount overdrawn does not, at anytime exceed the agreed limit. Interest is charged only on the amount actually utilized. It is calculated on the daily product basis. Overdraft accounts may be unsecured, partly secured or fully secured. Securities normally accepted against an overdraft include shares, government promissory notes, fixed deposit receipts and life insurance policies. .

3. CASH-CREDITS

Cash credit arrangement is similar to overdraft except insofar as overdraft can be granted only where a current account is in existence. Cash credit like an overdraft is an operative account subject to the limit sanctioned. It is normally utlilised by traders, industrialists, agriculturists, etc, for meeting their working capital requirements. The security usually accepted in a cash. Credit account are commodities like cotton, sager jute, metals etc.

4. DISCOUNTING OF BILLS

One of the modes of advancing money by banks is throw discounting of bills of exchange. A discounter is a holder for value. He is not a pledgee. Banks provide financial help to their customers by discounting their Bills of Exchange which are due for maturity at a future date. They also discount their outstation cheques and credit the amount to customers account even before clearing of the cheques. While discounting the bills, the backs deduct the amount of discount from the bill.

STUDY OF THE BORROWERS (OR) CREDIT WORTHINESS OF BORROWERS

The study of a borrower involves the study of the three c_s of the Pagty ie Character, Capacity and Capital. These c_s is are sometimes also refened as three

Rs. i.e. Reliability, Responsibility and Resource. Some American authors have preferred to add two more cs to these, viz, collateral and condition (economic). These factors gain atmost importance where the loan advanced is an unsecured one.

1. CHARACTER

The character of the borrower indicates his intention to repay the amount advanced. A banker usually avoids bad characters (ie dishonest and persons with no integrity) even if collateral security is being offered, as he may, infact, have no title or his title may be defective. However, honesty alone does not constitute character. The word character implies and includes a number of personal characteristics of a person, e.g, his honesty, integrity, regularity and promptness in fulfilling his promises and repaying his dues, sense of responsibility, good habits and the reputation and good will which he enjoys in the eyes of others. If a person possesses all these qualities, without any doubt or suspicion in the minds of others, he possesses and excellent character and will be considered creditworthy by the banker.

2. CAPACITY

The success of an enterprise largely depends upon the ability, competence and experience of the entrepreneur. If the borrower possesses necessary technical skill, managerial ability and experience to run a particular industry or trade, success of such unit may be taken for granted and the banker will consider him a deserving case for granting an advance. The significance of this function is now growing as the banks are willing to grant unsecured loans to technicians and competent persons on the basis of soundness of their business projects, irrespective of their own capital.

3. CAPITAL

Banker is supposed to look into the capital aspect of the customer insofar as the success of a business can never be guaranteed. In the even of the loss, the costumer's capital worries as the cushion and the loss is saved from being shifted to the banker. Normally, a bank does not lend more than the capital provided by the consumer himself, of course, in certain cases, e.g, in case of agriculturists or small scale industrialists, bankers do finance more than their capital.

Though all the above mentioned factors are important and taken into account by the banker at the time of assess the creditworthiness of a borrower, their relative importance differs form banker to banker and for borrower to borrower. The consideration of security is now undergoing a change. Greater emphasis is being laid on the ability and competence of the borrower and soundness of his Project However, persons of doubtful integrity and without good character are not granted unsecured advances.

UNIT-II

LOANS AND ADVANCES

SECURED AND UNSECURED ADVANCES

Before we discuss the different forms of advances in detail, it will be pertinent to note that advances may either be secured or unsecured.

Section 5(n) of the Banking Regulation Act, 1949, defines a secured loan or advance as.

“A loan or advance made on the security of asserts the market value of which is not at any time less than the amount of such loan or advance”.

An unsecured loan or advance means a loan or advance not so secured. An unsecured advance is also known as clean advance. A clean advance is more risky as there is no security to fall back upon in case the borrower makes a default in payment. Therefore, the capacity, character and capital required of a borrower seeking an unsecured advance have to be of a higher order than in the case of a secured advance. A clean advance is generally granted for a very short period.

SECURED ADVANCES—TYPES OF SECURITIES

Advances Against Goods

The term 'goods' has been defined under Section 2 (7) of the Sale of Goods Act, 1930, as "every kind of movable property other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to and forming part of land which are agreed to be severed before sale, or under the contract of sale". Movable property is defined as property of every description other than immovable property. In lending against the security of goods, bankers are generally guided by a list kept by them of approved commodities. Commodities other than those specified in the list are also accepted provided they are easily marketable, have a steady demand and do not run the risk of deterioration.

Merits

1. **Tangible Security :** Goods are a better security than guarantees and bills of exchange because they enable the banker to fall back upon something tangible in case of borrower’s failure to pay the debt.

A banker making an advance against goods is generally able to recover the amount due, in case of customer's failure, by selling the goods. If any balance remains unsatisfied, he can prove his claim against the estate of the debtor.

2. **Freedom from heavy fluctuations in prices :** The second advantage in favour of goods as a security is that if goods retained as security are necessaries of life, e.g., wheat, sugar, cotton, etc., their prices in normal times are not subject to wide fluctuations.

3. **Easy to sell**: Goods can be sold more easily than certain other types of

securities such as land, buildings, etc., particularly where the commodities pledged are necessities of life.

4. **Advances only for short periods**: Advances against goods are generally seasonal and consequently for short periods. The banker lending funds against goods, therefore, does not have to lockup his money for any considerable length of time.

5. **Easy to evaluate**: The prices of produce and goods can be more easily and accurately ascertained through daily quotations in the newspapers of produce exchanges. On the other hand, ascertaining the prices of immovable properties is a difficult task.

6. **Control:** It is possible to keep the goods under the bank's lock and key. Thus, the possibility of repledging by the customer is avoided.

Demerits

As against the above advantages, these securities suffer from the following defects :

1. **Risk of deterioration** : Most of the commodities arc liable to deterioration and damage unless properly stored. For instance, banker advancing money against fruits, vegetables, etc., has to see that they are sold before decaying. Even wheat, if stored for more than six months or so is likely to be damaged by white ants.

2. **Fall in prices :** Where the goods kept as security are not necessaries but are luxuries or comfort goods, their prices may fluctuate widely due to changes in fashion.

3. **Greater risks of fraud :** The quality of the goods pledged may be inferior to what is stated in the invoice. Absence of proper standardization in the quality of goods—specially in the case of agricultural goods such as grains, oil-seeds etc.—gives opportunity to unscrupulous persons for adulteration. Besides quality, there have been instances where advances were made against certain bags said to contain sugar, but most of them were found containing sand or sawdust.

4. **Storage and verification:** Attached with the problem of storage is the problem of constant verification of the stock. Cases have been noted where goods were removed by the pledges in connivance, with the godown-keepers, thus reducing the security of the bank.

5. **Transportation**: Transportation of goods from place to place as and when required, is also difficult due to their bulk and weight.

6. **Valuation** : The varieties of some of the goods arc so numerous that valuation becomes a problem.

Precautions

As noted above, goods as a security against advances have certain risks associated with them, a banker therefore should take the following precautions to safeguard his position :

1. Borrower to be trustworthy and experienced: As there is a possibility of fraud being exercised by the customer, the banker must see that the customer who wishes to borrow money against the security of goods is trustworthy, prudent and has practical experience of the goods which he is handling.

2. Banker to be familiar with the commodity markets : Not only should the banker, engaged in advancing money against the security of goods be familiar with the different commodity markets, but also should have a first hand knowledge of the conditions and customs peculiar to each trade.

3. Nature of the commodity: In order to realise the security as and when the banker finds it essential, he should accept only such commodities as are readily saleable. Moreover, the goods accepted should not be subject to deterioration for a considerable time.

4. Storage : Great care should be exercised in storing the goods not only to avoid their deterioration, but also to guard against pilferage.

The bank's name plate should be displayed in front of the godown and all other conspicuous places to notify the bank's possession.

5. Goods or commodities should be necessaries of life: To safeguard against fluctuations in prices, as far as possible, the goods accepted as securities should be necessaries of life.

6. Proper care in valuation: Wherever valuation appears to be difficult, services of experts should be obtained as overvaluation may endanger bank's funds to the extent goods are overvalued. .

7. Insurance of goods: The banker should see that the goods, against which money has been advanced, are insured against loss by theft, fire etc. and the insurance premium are regularly paid by the customer.

8. Adequate margin: Adequate margin should be maintained in case of advances against goods. A higher margin should be insisted on goods subject to wide fluctuations.

9. Licences: In case of advances against commodities like cotton, tobacco, etc., requiring licence for dealing, storing, transporting, etc., the relative licences or permits or copies thereof should be verified and retained.

10. Periodical inspection: Periodical inspection of godowns at irregular intervals should be undertaken, to note any discrepancy in the list of commodities pledged or hypothecated and the goods stored in godowns or in the borrower's premises.

Inside the godown, a chart should be kept indicating the quantity of goods. As and when the deliveries are made they should be recorded on the same chart.

11.Hypthecation agreement: Besides the precautions mentioned above, a banker should cause the following clauses to be inserted in the Letter of Pledge or Hypothecation :

(a) In case of default in repayment, banker shall be authorised to sell the whole or a part of the goods pledged or hypothecated ;

(b) Storage charges shall be payable by the customer ;

(c) Goods pledged or hypothecated shall be a continuing security.

12.Honest godown-keeper: Godown-keeper and watchmen should be men of integrity, otherwise the possibility of their collusion with the fraudulent borrowers is more and that will be seriously detrimental to the interest of the bank,

Advances Against Document of Title to Goods

An advance against the pledge of documents of title to goods is tantamount to the pledge of the goods themselves. In the case of advances against document of title to goods, the ultimate security is the stock of goods represented by the documents and not the documents themselves.

The usual documents of title to goods are :

1. Bill of lading;
2. Railway receipts;
3. Ware housekeeper’s certificates and receipts;
4. Dock-warrants;
5. Delivery orders.

1. Bill of Lading

A Bill of Lading is a document issued and signed by the ship-owners or their agents acknowledging that the goods mentioned in the bill have been duly received on board and undertaking to deliver the goods in the like order and condition as received, to the consignee or to his order or assigns, provided that the freight and any other charges specified in the Bill of Lading have been duly paid. The shipping company does not certify the actual contents of the packages or bales. It is only a prima facie evidence that the packages, etc., with special markings or numbers were received by the company. A bill of lading is issued in triplicate, all of which are signed.

2. **Railway Receipts**

A railway receipt, like bill of lading, is an acknowledgement of goods received by the railways for carriage. Again, like a bill of lading, the property in goods may be transferred by endorsement and delivery of the railway receipt. However the

title of the transferee, even though a bona fide holder, will always be subject to the defects in the title of the transferor himself. Under Sec. 50 of the Sale of Goods Act, 1930, the unpaid seller who has parted with the possession of the goods has the right of stopping them in transit if the buyer of the goods becomes insolvent. But the transfer of a railway receipt, while the goods are still in transit, defeats the unpaid seller's right of stoppage in transit provided the transferee took it in good faith and for consideration.

3. Ware housekeeper's Certificates and Receipts

A warehousekeeper's certificate is an acknowledgement of the receipt of specified goods to be held at the disposal of the person specified. Such a certificate is usually marked non-transferable. But, Sec. 2(4) of the Sale of Goods Act, 1930, declares them as 'Documents of Title to Goods'. The banker should therefore be very careful in accepting such receipts or certificates as security, the banker should in fact arrange to have the certificate issued in his own name. Further, the banker should always carry out a periodical inspection of the goods advanced against to ensure that they are in order and properly stored. An insurance policy against fire and theft should also be insisted upon.

4. Dock Warrants

A dock warrant is an acknowledgement of receipt of goods by a dock company to be held at the disposal of the person mentioned therein. Such documents, like bill of lading, are transferable by endorsement and delivery. But again like a bill of lading, the title of the transferee is subject to the defects in the title of the transferor himself. A banker, therefore, should accept such documents only from persons of honesty and integrity.

5. Delivery Orders

These are orders addressed to the warehouse keepers from the owners of goods to deliver the mentioned goods to a specified person. Delivery orders are transferable by endorsement and delivery. Banker advancing against these orders should preferably get the goods transferred to his own name. Further, the value of the goods and honesty and integrity of the customer should also be considered.

Advances Against Stock Exchange Securities

The term 'Stock Exchange Securities' refers to those securities which are dealt with on the stock exchanges. The securities dealt with on the stock exchanges are :

i. Securities issued by Central as well as the State governments ;
ii. Semi-government securities like port trust, improvement trust and municipal bonds and debentures ; and
iii. Shares, stocks, bonds and debentures of joint stock companies.

Government Securities

The term 'Government Securities' includes securities issued by Central as well as State governments, from time to time, to raise loans. Government securities are safe

and easily realisable and, therefore, are also known as gilt-edged securities. Verification of title is not difficult and the supervision is also easy as securities remain in the bank's custody. Further, as these securities are dealt by stock exchanges, it is very easy to ascertain their prices through quotations in daily newspapers. The prices of these securities do not fluctuate widely.

The above-mentioned merits of government securities make them as one of the best securities for advances by the banker. There are three forms of government securities:

1. Inscribed stock
2. Bearer bonds
3. Promissory notes.

Inscribed stocks

They are so called, because the name of the holders of such stocks and the amount of their holdings are "subscribed" i.e. recorded in the books kept either with the government, or the corporation issuing the same, or its agents. The holder of such stock does not receive any certificate of title but merely gets a receipt of acknowledgement which is not transferable by endorsement. A special form of transfer, however, is printed on the reverse of the certificate. The title to the inscribed stock can be transferred on the completion of the transfer form and registration of the transferee's name with the Public Debt Office. A fresh certificate is thereafter issued in the name of the transferee.

Precautions

A banker while advancing against inscribed stock should take the following precautions :

1. The banker should get the stock transferred to his on name or to that of his nominee as no charge can be claimed by the deposit of the stock receipt or even by an endorsement on it.
2. When stock certificates to bearer with interest coupons attached, or registered stock certificates, can be obtained at the holder's option, the banker must insist the borrower to obtain them.
3. Only reliable parties should be accommodated. The inscribed stock is not very popular because of difficulties connected with the transfer.

Promissory Notes

Most of the Government securities are in the form of promissory notes. A government promissory note is a negotiable instrument signed by the President of India in the case of Central Government loans and by the Governor of the State in the case of State loans. The title can be transferred by endorsement and delivery.

Precautions

Although government promissory notes are one of the safest and easily realisable securities for bank advances, following precautions may be taken by a banker to further secure his interests :-

1. Title to the promissory note can be transferred by endorsement and delivery. But to safeguard his position against forgery, a banker should ask
the borrower to have the securities renewed in his (borrower's) favour if they bear a number of endorsements, and thereafter to endorse in favour of the banker. Besides a letter of pledge should also be extended in favour of the banker.
2. The banker-should also take a letter from the borrower authorising him to receive interest on the securities, which is usually paid every six months.
3. The banker must see to it that no prior charge has been created.
4. The banker must retain the possession of the securities till the advance is repaid in full, because if they are released, the borrower may transfer the legal title to any other person.
5. The banker must also require the borrower to sign a memorandum authorising the banker to sell the securities in case he makes default in making payment.
6. In case the borrower is a limited company, the lending bank should ensure that the power of attorney of the officer endorsing the Government promissory notes has been registered with the Public Debt Office. Similarly, if the borrower is a firm, its constitution should be registered with the Public Debt Office.
7. In making advances against government promissory notes which may be either as a fixed loan or a fluctuating loan like cash-credit, a margin of 10 to 15% should be maintained to cushion price fluctuations and the accruing interest.

Semi-Government Securities

Semi-government securities include bonds and debentures issued by bodies like Port Trusts, Improvement Trusts, Municipal Corporations, etc. Though not as reliable as government securities, bankers consider them as quite safe and freely lend against them with proper margin.

Shares of Joint Stock Companies

With a view to eliminate undesirable securities being accepted as cover for its advances and to save time, every modern bank prepares a list of approved shares. While preparing such a list, banks take into account the following points :-

1. Age of the company.

2. Examination of the financial statements of the company and their general working.
3. Nature of the business of the company.
4. Reputation of the company and its directors.
5. Marketability of the shares.
6. Fluctuations in prices of the shares.
7. Accumulated reserves.
8. Prospects of the industry in general and the company in particular.

Merits

Advances against shares form an important part of the loans made by commercial banks because of the following reasons :

1. Tangible security. As compared with guarantees, shares are generally more reliable as the banker gets something tangible. In case of guarantees, he has to rely entirely upon the solvency of the surety for recovery in case the borrower fails to pay.

2. Easy realisability. Shares of high class companies are more easily realisable than lands and buildings and goods of certain kinds because stock exchanges provide a ready market for good securities.

3. Price stability. Ordinarily, the prices of shares of reputed companies do not fluctuate widely.

4. Establishment of title. It is not very difficult to ascertain the title to the shares. The books of the issuing company can be consulted to find out the customer's title.

5. Valuation. The market price of shares can be very easily ascertained from the quotations appearing in the daily newspapers and those supplied by stock and share brokers.

6. Transferability. Shares are more easily transferable than certain other class of securities like lands and buildings. Comparatively, it requires very little formalities. The duly filled transfer form signed by the transferor has to be presented to the company and that entitles the banker to hold the shares in his own name.

7. Release. The release of shares can be effected very easily and involves minimum of expense and formality.

8. Accrual of income. The securities yield income in the form of dividend. The income received reduces the borrower's indebtedness.

9. No problems of storage.

Demerits

1. In case of partly paid shares, the banker may be called upon to pay the uncalled amount, where he or his nominee is registered as their owner.

Moreover, the articles of association of companies generally provide that their shares will be subject to a lien in case of default in the payment of any amount due on them.

2. In case of shares subject to wide fluctuations, the banker may suffer a loss if adequate margin is not kept.
3. There is a possibility that share scrips be forged ones thereby making the advance difficult to realise.

Precautions

1. The banker should see to it that the shares are not partly paid. If, however, the banker is confident that there is no likelihood of any further calls being made, he may not reject shares merely on the ground of an uncalled liability.
2. The suitability of shares as security for bank advances depends upon their market price and easy marketability which in turn depends upon the nature of business of the company, the competence of management and past financial results.
3. Generally, the prices of shares quoted in newspapers are cum-dividend. The banker should, therefore, deduct such dividend from the quoted price to ascertain correct value of the shares.
4. Where an equitable charge is created, i.e., the securities are deposited with the banker without registration of the transfer, there is the risk of subsequent legal title being created through duplicate share certificates. The banker should, therefore, send a letter to the company informing about the charge over shares in its favour, so that no duplicate share certificate is issued. Besides the banker must ask the borrower to sign the memorandum authorising the banker to sell the securities in case he default in making payment.
5. The general principles of good lending should be followed.

Debentures/Debenture Stock

Debenture is a document representing a debt borrowed by the issuing company. "Debenture", says R.S.T. Chorley, in his 'Law of Banking', "is the name given to the document by which a limited company acknowledges receipt, of money which it promises to repay with interest at a future date (usually fixed), and mortgages or charges its assets as security for its borrowings." Debentures are usually issued by incorporated companies though unincorporated bodies like clubs, associations etc. may also issue such a security.

Debentures like shares and government securities belong to the category of stock exchange securities. They may be redeemable or irredeemable, secured or unsecured, but they are accepted, as security if only they are readily marketable.

Precautions

Before debentures are accepted for security, the following factors should be carefully considered :

1. The reputation and financial position of the issuing company.
2. The authority of the company to issue debentures. Issue of debentures tantamounts to borrowing by the company. The banker must, therefore inspect the memorandum of association to find out whether it gives the Company power of borrowing, though in case of trading companies this power is implied.
3. The terms on which debentures are issued.
4. The manner in which they are secured, with floating or fixed charges.
5. The regularity in payment of interest.
6. The marketability of debentures.
7. The managerial capacity and integrity of the company's directors, etc.

Advances Against Life Insurance Policies

At one time life insurance policies were condemned as security for bank advances. Gilbart (J.W.) in his "Logic of Banking" observed, " a banker should never make advances upon the life policies". The unpopularity of life insurance policies as security for bank advances was probably because of the following reasons :

1. Contract being uberrimae fidei. A contract of life insurance is a contract uberrimae fidei, requiring utmost good faith on the part of the assured. So, in case any material fact is found to have been concealed, the insurance company can avoid its liability.

A banker has no means of knowing whether the insured has disclosed all the material facts concerning his life.

2. Failure to pay premium terminates the policy. In case, the assured fails to pay premiums regularly, after getting loan against a policy, the policy will terminate unless the banker pays premiums to keep the policy alive.

Life insurance policies are one of the most commonly acceptable securities. Sheldon in his "Practice and Law of Banking" supports life insurance policies as security for bank advances, because the longer they are held, the higher their value becomes. Where the advance is linked to the surrender value, there is complete safety for the banker because if the borrower makes default, the banker can get the loan repaid by surrendering the policy. All securities, howsoever liquid and safe they may be, have some drawbacks, and life policies are no exception.

Merits . Besides, life insurance policy is considered good as security because of the following reasons:

1. **The policy can be legally assigned to the banker:** A life insurance policy can be assigned to anybody including a banker, and such an assignment is duly registered with the Life Insurance Corporation. By such an assignment, the banker becomes entitled to receive payment on maturity or death of the borrower.

2. **Surrender value** : The surrender value of the policy increases with the maturity of the policy and thus the value of the security automatically increases to cover the accruing interest on the amount advanced.

3. **Easy supervision**. The supervision of a policy that is delivered to the banker is simple, the banker has only to keep an eye on the premium payments.

4. **Self-liquidating**. The loan becomes self-liquidating in the event of the death of the borrower.

Drawbacks:

As against the above-mentioned merits, life insurance policies as a cover for advances, are subject to the following drawbacks :

1. A contact of insurance is a contract uberrimae fidei, requiring utmost good faith on the part of the assured. Non—disclosure of material facts within his knowledge will absorve the insurance company of its liability. A banker has no means of knowing whether the assured has disclosed all the material facts concerning his life, and if the assured has been guilty of fraud or misrepresentation, the banker stands the risk of losing his money.

2. Insured's failure to pay the premium regularly causes lapse of policy. The surrender value is payable only when the policy has run a certain minimum period. The banker, thus, runs the risk arising out of the non-payment of the premium.

3. Policies, usually, contain a 'suicide clause[1] whereby if the assured commits suicide within a particular period, the policy becomes invalid.

Precautions : The following precautions should be observed by bankers while accepting life insurance policies as security :-

1. Endowment policy preferred : The bankers should prefer endowment policy to whole life policy as there is a definite maturity date in case of the endowment policy whereas in case of whole life policy money is payable only in the event of death of the insured.

2. Insurable interest necessary. Insurable interest is necessary for the validity of a life policy. Insurable interest is presumed in certain cases such as:—

(a) That of a person in his/her own life;

(b) That of a husband in the life of his wife; and

(c) That of the wife in her husband's life.

Where the policy is taken by a third person, the banker should satisfy himself that he has an insurable interest in the life of the insured.

3.Restrictions on assignment. The banker should make it sure that there are no restrictions on the assignment of the policy.

4. Admission of the age. The banker should see that the age of the insured has been admitted by the Life Insurance Corporation. If not, he should get the age admitted before loan is sanctioned.

5. Ascertainment of the surrender value. Before making any advance against a life policy, the banker must ascertain its surrender value.

6. Margin. Generally, the banker should not advance more than 85% of the surrender value of the policy. In the event of an endowment policy due to mature after a comparatively shorter period, however, the banker may exceed this percentage particularly when he is confident of regular payments of premium.

Above all, only the honest and trustworthy customers should be accommodated because the contract of insurance is a contract uberrimae fidei and non-disclosure of any material fact terminates the Corporation's liability on the policy.

Advances Against Fixed Deposit Receipts

A fixed deposit receipt is an acknowledgement of receipt of the specified amount repayable after the specified period of time. Customers sometimes require advances against their fixed deposit receipts with the bank maturing at a future date. Though, banks are not bound to allow such advances, they normally extend this facility. While making advances against a fixed deposit receipt, a banker should take certain precautions.

Precautions

1. No advance should be made against a fixed deposit receipt issued by another bank, as the latter has a paramount lien on the deposit receipt issued by it and may refuse to register the lien of the lending bank.

2. Advance should be granted only to the person in whose name the deposit receipt is issued. If the deposit is in two or more names and loan is to be granted to one of them, all the depositors should sign a letter of authority.

3. In the case of deposits in the names of minors, loans may be granted provided a declaration is obtained from the guardian that the money belongs to him, but has been kept in the minor's name as a matter of convenience and the amount of advance is intended to be utilised for the benefit of the minor.

4. The deposit receipt should be discharged by all the depositors on an appropriate revenue stamp. Even where deposit is payable to "either or survivor" or "anyone or survivor", discharge by all the depositors must be obtained. The signatures must be tallied with the specimen signatures in bank's record.

5. The bank must take actual possession of the receipt with a letter signed by the depositor/depositors authorising the bank to appropriate the proceeds of the receipt on maturity, in case the customer fails to pay the loan on due date.

6. The bank should make a note of its lien across the fixed deposit receipt as well as in the fixed deposit register and ledger.

7. While advancing against the receipt of another branch of the bank, It should confirm that no loan has already been advanced against that deposit. It should, after granting the loan, intimate the branch which issued the deposit receipt to note and confirm its lien. A letter should also be taken from the customer to remit the proceeds to the lending branch on maturity.

8. A margin of 5 per cent to 10 per cent is usually kept on loans against fixed deposits. In the case of cash certificates issued by the bank, the margin is calculated on the current value (surrender value) of the certificates.

9. In case, loan is advanced against a fixed deposit receipt in the name of a third party, along with the usual documents from the party, the banker takes the fixed deposit receipt duly discharged by the person in whose name the deposit stands. Also, a letter of approval to apply the proceeds of the receipt, in case loan is not paid, is taken from the party in whose name deposit receipt is issued.

10.Interest on loans against fixed deposit is now governed by the Reserve Bank of India directive. Banks arc required to charge a minimum of 2 per cent above the interest payable on such deposit. Thus, for example, if a loan is advanced on the security of a fixed deposit receipt carrying interest @ 9% per annum, the bank must charge interest at the minimum rate of 11 per cent per annum. He may, of course, charge a rate higher than this.

Advances Against Land and Buildings

Though land and buildings are tangible assets, bankers do not generally advance money against them. Bankers are reluctant to accept land and buildings (real estate) as security because of the following reasons :

1. Difficulties in ascertaining the customer's title. The holders of title deeds of land may not be the absolute owners. The law relating to the subject is very complicated and therefore ascertaining whether the borrower has a good title may be a difficult task. Sometimes, the title deeds may refer to a large plot of land but a considerable portion of the same might have been sold without such sales having been endorsed on the original deed. The problem of establishing the title is more complicated in case of agricultural land because land records arc not properly maintained. Further, "the rules of succession" are also complicated under Hindu and Mohammedan laws and thus person/persons claiming ownership may not be established as the absolute owners.

2. Restrictive nature of the laws. Particularly regarding agricultural lands, transfers are restricted. A non-agriculturist cannot acquire agricultural land from an agriculturist. Again, restrictive nature of Hindu as well as Mohammedan laws and customs relating to transfer of property put serious obstacles in the way of banks financing against real estate.

3. Frigid nature of the security It is a frigid security. Land has no easy and ready marketability because of protracted legal formalities for its sale. Such securities, particularly in times of financial stress, are almost unsalable. Even

where a buyer is found, it takes considerable time in drafting the sale deed and its registration.

4. Difficulty in valuation. Valuation of real estate is a difficult task. A banker cannot rely on its own judgment for that purpose. Nor can its book value be accepted as it is because a banker is interested in knowing the realisable value which may be far less than its book value. Book value or cost of construction may be high because of its special type of construction to suit the owner's taste but in fact it may not add materially to the value of property for the purposes of ordinary tenancy. The situation or locality also affects the realisable value of the property.

5. Administration of properties. The banker as the mortgagee of land and buildings may sometimes be required to administer the land and buildings and carry out repairs, collect rents and keep accounts.

Precautions that a banker should take

1. The banker should preferably get a mortgage-deed executed and registered, i.e., should prefer legal mortgage. In case equitable mortgage is created, the banker runs the risk of a subsequent legal mortgage being created by the borrower in favour of another party. If a person lends upon a legal mortgage without either a sight of the deeds or a reasonable explanation of their non-appearance, he will get a charge prior to the equitable mortgagee.
2. The banker should engage expert valuers to ascertain the value of the properties to be mortgaged. The costs so incurred should be charged from the borrower.
3. The banker should insist that the properties mortgaged are insured against fire, riots etc., and the policy assigned in favour of the bank. The properties should be insured for full value irrespective of the loan amount so as to avoid the application of "average clause".
4. The instructions of the mortgagor should be carefully carried out. In **Punjab National Bank Ltd** vs. **Diwan Chand and Others** (A.I.R. 1931 Lahore 302) the banker failed to carry out the mortgagor's instructions regarding renewal of insurance of the mortgaged properties and as a result the mortgagor suffered loss, the bank was held liable to compensate for the loss suffered.
5. As noted earlier, establishment of borrower's title is a complicated job, the banker should consult its solicitors to investigate and confirm the borrower's title. The solicitors should be asked to give a certificate confirming the validity of the title of the mortgagor.
6. The banker should see to it that the mortgagor of leasehold lands pays the ground rent as per schedule and also taxes due to be paid to the Government. He should get the receipts of such payments and preserve them along with title-deeds.

An adequate margin should be maintained. As land and buildings are not easily realisable, bankers normally keep a margin ranging between 33% and 50% of the value of the property.

Various Modes of Creating Charge

While advancing money, banker must secure his position. Not only that he should insist on good security but the method of charging it should be legal and perfect. He should see to it that all the necessary formalities have been complied with so that in case of default by the borrower, he has a right to proceed against the securities and satisfy his claim. The securities may be charged by any of the following ways:

1. Lien
2. Pledge
3. Hypothecation
4. Mortgage
5. Charge
6. Actionable claims.

LIEN

A lien is the right of a person in the possession of goods, to retain them until debts due to him have been satisfied. A lien may be particular or general.

A particular lien is a right to retain the goods in respect of which the debt arises. Thus, a particular lien can be exercised by a person who has spent his time, labour and money on the goods retained, e.g., a scooter repairer may retain the scooter till the repair charges are paid for or a tailor may retain a stitched suit to claim his stitching charges. A general lien on the other hand arises out of the general dealings between two parties and covers any property that the one party may be holding for the other. Banker's lien is a general lien.

Under Section 171 of the Indian Contract Act, 1872, bankers, in the absence of a contract to the contrary, can exercise general lien and retain as security for a general balance of account, any goods bailed to them. So, no agreement is necessary to create the right of lien as it is implied by the terms of Section 171 of the Indian Contract Act. However, for the exercise of such lien, the securities must have been received by the banker as a banker. But bills and documents left for collection are part of banker's ordinary business and he has a lien upon them. There is a lien upon bonds and coupons deposited for collection, and where the bonds are given by the customer himself for collection, the lien attaches only to the coupons so given for collection and not to the bonds.

The lien also extends to all securities held by the banker as cover for any specific loan, but left with him after the loan has been repaid.

Banker's lien is more extensive than an ordinary lien. It has been called an implied pledge

So when a banker's lien is considered as an implied pledge, it gives him the right of a pledgee, i.e., the right to sell by giving a reasonable notice, and no suit be filed for seeking the right of sale.

However, this right of lien cannot be availed of by the banker in the following circumstances:—

1. Where the goods or securities have been deposited for a specific purpose.
2. Where the valuables are deposited in safe custody of the banker.
3. Where money is paid to meet specific bills accepted payable at the banker.
4. It does not also extend to the title deeds casually left at the bank. Similarly, no lien can be exercised in respect of documents or valuables left inadvertently with the banker, or on property which is placed in his hand with the object of covering an advance which is not granted.
5. No lien can be exercised in respect of trust accounts. But if the bank has no knowledge and it has not, during the currency of the account, received notice of the trust character of the funds, the lien can be exercised.

Banker's Lien and the Limitation Act

The banker's right of lien is not barred by the Law of Limitation. The effect of the Limitation Act is only to bar the remedy and not to discharge the debt. Consequently, it does not affect property over which the banker has a lien.

PLEDGE

Section 172 of the Indian Contract Act. 1872 defines a pledge as the bailment of goods as security for payment of a debt or performance of a promise. Bailment, as per Section 148 of the Indian Contract Act. means the delivery of goods by one person to another for some purpose, under a contract that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person, who delivers the goods, as security is called the 'pledger' and the person to whom the goods are so delivered, is called the 'pledgee'. The ownership remains with the pledger. It is only a qualified property that passes to the pledgee. He acquires a special priority and lien which is not of ordinary nature and so long as his loan is not repaid, no other creditor or 'authority' can take away the goods or its price.

Delivery Essentials

A pledge is created only when the goods are delivered by the borrower to the lender or to someone on his behalf with the intention of their being treated as security against the advance. Delivery of goods may, however, be actual or constructive. It is constructive delivery where the key of a godown in the goods are kept or documents of title to the goods are delivered. Similarly, where the goods continue to remain in the borrower's possession but are agreed to be held as a 'bailee' on behalf of the pledgee and subject to the pledgee's order, it amounts to constructive delivery and that amounts to valid pledge.

Advantages of Pledge

To a banker, pledge is perhaps the most satisfactory' mode of creating a charge on securities. It offeres the following advantages :—

1. The goods are in the possession of the bank and therefore, in case the borrower makes a default in payment, they can be disposed of after a reasonable notice.
2. Stocks cannot be manipulated as they are under the banker's possession and control.
3. In the case of insolvency of the borrower, bank can sell the goods and prove for the balance of the debt, if any.
4. There is hardly any possibility of the same goods being charged with some other party if actual possession of the goods is taken by the banker.

Who may Pledge ?

Besides owner of the goods, any of the following persons may create a valid pledge :

1. Mercantile agent who is in possession of goods or documents of title to goods with the consent of the owner.
2. A person who has obtained possession of goods under a voidable contract and that contract has not been rescinded at the time of the pledge.
3. A seller who continues to be in possession after sale, with the consent of the buyer.
4. A buyer in possession of the goods, with the consent of the seller, after agreement to sell but before completion of sale.
5. A pledgee may create a valid pledge by repledging the goods and the pledge is valid to the extent of his interest in the said goods.

Rights of a Pledgee

According to Sec. 176 of the Indian Contract Act, 1872, in case the pledger fails to pay his debt or completes the performance of obligation at the stipulated time, the pledgee can exercise any of the following rights :

1. Bring a suit against the pledger upon the default in redemption of the debt or performance of promise and retain possession of goods pledged as collateral security.
2. Sell the things pledged on giving the pledger reasonable notice of sale.

In case the goods pledged when sold do not fully meet the amount of the debt, the pledgee can proceed for the balance. If, on the other hand, there is any surplus, that has to be accounted for to the pledger.

Before sale can be executed, a reasonable notice must be given to the pledger so that:

(a) The pledger may meet his obligation as a last chance.

(b) He can supervise the sale to see that it fetches the right price.

Duties of Pledgee

1. The pledgee is required to take as much care of the goods pledged to him as a person of ordinary prudence would, under similar circumstances, take of his own goods, of a similar nature.
2. The pledgee must not put the goods to an unauthorised use.
3. The pledgee is bound to return the goods on payment of the debt.
4. Any accruals to the goods pledged belong to the pledger and should be delivered accordingly.

Banker as the Pledgee

A Banker when accepting goods under pledge should take a letter of pledge from the customer to include the following declarations :

1. That the bank shall have a pledge upon all the goods and documents of title delivered to him by the customer or his agent.
2. That the goods are being pledged as a continuing security to cover the existing and future debt, i.e., the amount of the loan, interest and expenses.
3. That the customer shall keep the goods insured against fire.
4. That the customer shall not repledge or otherwise encumber any of the goods pledged till the continuance of this agreement.
5. That the customer undertakes to submit periodical statements of stocks and to allow at his cost inspection by the bank from time to time of the goods as well as the borrower's records.

HYPOTHECATION

Hypothecation means creating some claim in goods or related documents without transferring their possession to the lender. Hart describes hypothecation as a "charge against property for an amount of debt where neither ownership nor possession is passed to the creditor." Holden says, hypothecation is "a legal transaction, whereby goods may be made available as security for a debt without transferring either the property or the possession to the lender." Thus, in hypothecation, the goods remain in the possession of the borrower but, he binds himself under hypothecation agreement to give possession of the goods to the creditor when called upon to do so.

The goods are charged under hypothecation particularly where pledge is either inconvenient or impracticable. For example, where he security offered is either raw-materials or work-in-progress. Under this arrangement, the borrower is allowed to use the stock, sell it and replenish it by new one. A floating charge is created over the movable assets of the borrower.

As in hypothecation, the goods remain in the possession of the borrower, this facility should be granted only to parties of utmost honesty and proven integrity. Besides, a banker should take the following precautions :

a. The banker should obtain periodical statement of stock, stating the figure of opening stock, purchases, sales and closing stock for the period covered by them. These stock statements must be signed by the authorised persons.

b. In case borrower is a joint stock company, the bank's charge must be registered with the Registrar of Joint Stock Companies within a period of 30 days of the creation of the charge. In case it is not registered within this period, it becomes void against the liquidator and/or any other creditor of the company.

c. Where the company's financial position does not justify the granting of an advance on hypothecation basis, it is sometimes reinforced by the personal guarantee of its directors, where they are persons of substantial means. Personal guarantee of directors is usually taken in the case of advances to private companies. It is because, the relationship between private company and its directors is more personal than that in a public company.

2. The banker should ensure that the hypothecated stocks are fully insured against fire and other risks.

3. Periodical inspection of the stocks should be carried out to verify the correctness of the stock statements submitted by the borrower.

a. As the borrowers who are granted hypothecation facility are highly creditworthy, the inspecting officer must exercise considerable discretion and tact in verifying the stocks and looking into their accounts. At the same time the banker's interest must be looked after and any deterioration in the security must be duly reported so that appropriate action is taken in good time.

4. A name plate of the bank stating that the stocks are hypothecated to it must be displayed at all conspicuous places in the premises where the stocks are kept. This is done to avoid the risk of a second charge being created on the same stocks.

Guidelines Issued by **the Reserve Bank to check Double Financing**

In case of hypothecation of stocks, since the possession remains with the borrower, there is the risk of the same stock being hypothecated with more than one lender. To check such possibilities, Reserve Bank advised the banks to observe the following precautions :—

1. Before sanctioning any credit limit, the bank should ensure that the applicant is not enjoying similar facilities with other banks. In case he is having credit facilities from any other bank/banks, detailed information should be called for by the bank from those banks. As far as possible, parties should be advised to restrict their borrowing to only one bank.

2. The bank should obtain form the borrower a written application accompanied by a declaration about the existing credit arrangements and an undertaking that the stocks will not be hypothecated to any other bank

without the prior approval of the bank. The undertaking should be incorporated in the stock statement which the borrower is required to submit to the bank periodically. The terms of transaction should also stipulate that the advance will be recalled forthwith in case it is subsequently found that he has made a false statement in this regard.

3. Before granting credit facilities to the party, as also during the pendency of the advance, an officer of the bank should inspect the stocks with a view to ensuring that the same stocks have not been hypothecated to other banks. He should record such information in his report relating to his periodical inspection.
4. In case the borrower is allowed to avail himself of credit facilities against hypothecation of stocks from various banks, it should be ensured that such stocks are segregated or demarcated in different godowns/shops and the same are properly recorded in separate stock books so as to facilitate easy verification by the bank officials.

Hypothecation of Book-Debts

Advances are sometimes granted on hypothecation basis against the security of book-debts. This mode of charging book-debts is more convenient than the assignment of book-debts. The charge on book-debts is taken by means of a hypothecation deed or agreement specially drafted for the purpose. The borrower is required to submit statements of the outstanding debts hypothecated to the bank from time to time as in the case of hypothecation against goods. The agreement and statements form the basis of the advance against the security of book-debts. The statements contain interalia, the names and addresses of the borrower's debtors, the amounts due from them and the periods for which the debts have been outstanding.

Precautions

1. Banker should not advance against debts which have remained outstanding for an unreasonably long period, say, for over three (or sometimes six) months. The long unpaid debts should therefore be excluded while calculating the drawing limit.
2. Banks sometimes also assess the credit-worthiness of the debtors of the borrower, particularly when the amount of any debt is large.
3. The borrower's books should be inspected periodically and the correctness of the statements submitted by him verified.
4. Documents like D.P. note containing security letter, etc., should be taken as is done in case of advances against goods.
5. As an additional safeguard, a power of attorney in favour of the bank for collection of debts should be obtained from the borrower.

MORTGAGE

Mortgages are advances against immovable property. Section 3 of the Transfer of Property Act defines immovable property. It includes (i) land (ii)

benefits arising out of land, and (iii) things attached to the earth like trees, buildings and fixed machinery. Machinery, if not fixed, i.e, not permanently attached to the earth and which can be shifted from one place to another, is not an immovable property. Further the term 'immovable property' does not include grass or standing crop.

Section 58 of the Transfer of Property Act 1882 defines the terms : mortgage, mortgagor, mortgagee, mortgage-money, and mortgage-deed.

A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt or the performance of an engagement which may give rise to a pecuniary liability.

The transferor of property is called a mortgagor; the transferee thereof, a mortgagee; the principal money and interest of which payment is secured for the time being are called the mortgage-money and the instrument (if any), by which the transfer is effected is called a mortgage-deed.

The clause in an instrument by which the interest of mortgagor is transferred is called the hypothecation clause.

The borrower of money (i.e. , the debtor) is called a 'mortgagor' and the lender (the creditor) is called mortgagee. In other words, the creditor to whom a mortgage is made is mortgagee and the debtor who makes a mortgage is mortgagor.

Essentials of a Valid Mortgage

1. It must have all the essentials of a valid contract.
2. There must be a transfer of an interest in an immovable property
3. The interest transferred should be an interest in specific immovable property.
4. The purpose of the transfer should be to secure a debt and not to discharge it.
5. The mortgage must be to secure the performance of an engagement that may give rise to pecuniary (monetary) liability.
6. There must be two parties, i.e., mortgagor and mortgagee.
7. A minor cannot be a mortgagor, he can, however, be a mortgagee.
8. Mortgage should be effected by a written and registered document except :
   (i) in case of mortgage by deposit of title deeds.
   (ii) in case sum secured is less than Rs.100.
9. Once a mortgage, always a mortgage, i.e., a mortgage cannot be made irredeemable.

TYPES OF MORTGAGES

Section 58 of the Transfer of Property Act, contemplates the following six types of mortgages :

(i) Simple Mortgage

(ii) Mortgage by conditional sale

(iii) Usufructuary mortgage

(iv) English mortgage

(v) Mortgage by deposit of title deeds

(vi) Anomalous mortgage

Simple Mortgage

Section 58 provides as follows : Where, without delivering possession of the mortgaged property, the mortgagor binds himself personally to pay the mortgage-money and agrees, expressly or impliedly, that in the event of his failing to pay according to his contract, the mortgagee shall have a right to cause the mortgage property to be sold and the proceeds of sale to be applied, so far as may be necessary in payment of the mortgage-money, the transaction is called a simple mortgage and the mortgagee is a simple mortgagee.

Essentials of a Simple Mortgage

1. The mortgagor undertakes to pay the mortgage money personally.
2. The possession of the mortgaged property is retained by the mortgagor.
3. In the event of default, the mortgagee has the right to cause the mortgaged property sold.
4. In case mortgagor sells the mortgaged property, buyer shall take it subject to the mortgage but not subject to personal obligation by the mortgagor to pay.
5. Decree obtained by the mortgagee can be executed against the other properties of the mortgagor like any other money decree.

Mortgage by Conditional Sale

Section 58(c) provides as follows: Where the mortgagor ostensibly sells the mortgaged property on condition that

(a) on default of payment of the mortgage-money on a certain date, the sale shall become absolute, or

(b) on such payment being made, the sale shall become void, or

(c) on such payment being made the buyer shall transfer the property to the seller, the transaction is called a mortgage by conditional sale and the mortgagee, a mortgagee by conditional sale.

No such transaction shall be deemed to be a mortgage, unless one of the aforesaid conditions as to payment is embodied in the document which effects or purports to effect the sale.

Essentials of Mortgage by Conditional Sale

1. There is no personal liability on the part of the mortgagor to pay the

debt.

2. This mortgage contemplates an ostensible sale.
3. Ostensible sale is subject to a condition.
4. On default, ostensible sale ripens into a real sale.
5 Possession of the mortgaged property is not delivered to the mortgagee.
6. On payment, mortgagee has to re-transfer the property to the mortgagor.
7. 'Mortgage by conditional sale' is distinct from 'sale with a condition of re-purchase.
8. Remedy of a mortgagee by conditional sale is by foreclosure only.
9. Mortgagee cannot give up the condition as to sale and treat the mortgage as an ordinary one.

Usufructuary Mortgage

Section 58 (d) provides as follows : Where the mortgagor (1) delivers possession or expressly or by implication binds himself to deliver possession of the mortgaged property to the mortgagee, and (2) authorises him (a) to retain such possession until payment of the mortgage-money, and (b) to receive the rents and profits accruing from the property or any part of such rents and profits and to appropriate the same (i) in lieu of interest, or (ii) in payment of the mortgage money, or (iiii) partly in lieu of interest or partly in payment of the mortgage money, the transaction is called an usufructuary mortgage and the mortgagee an usufructuary mortgagee.

Essentials of Usufrcutuary Mortgage

1. Mortgagor delivers the possession of the mortgaged property to the mortgagee or expressly or impliedly agrees to do so.
2. Mortgagor is authorised to retain possession of the property until repayment of the mortgage-property.
3. Mortgagor is also authorised to receive rents and profits accruing from the property.
4. Only remedy of the mortgagee is to continue in possession of the mortgaged property till the advance is fully repaid.
5. If the mortgagor fails to bring the suit for redemption within 30 years, the mortgagee becomes the absolute owner of the property.
6. Registration of this type of mortgage is necessary if the mortgage money is Rs.100 or more.

English Mortgage —[(Section 58(e)].

Where the mortgagor binds himself to repay the mortgage money on a certain date, and transfers the mortgaged property absolutely to the mortgagee, but subject to a proviso that he will retransfer it to the mortgagor upon payment

of the mortgage-money as agreed, the transaction is called an English mortgage.

Essentials of English Mortgage

1. Mortgagor transfers the mortgaged property absolutely to the mortgagee.
2. Transfer of property is subject to the condition that the mortgagee shall re-transfer the same, on re-payment, to the mortgagor.
3. The mortgagor continues to be liable for repayment in spite of absolute transfer.
4. On default, mortgagor has right of private sale in certain circumstances.
5. The mortgage is put in possession of the mortgaged property.
6. Registration is compulsory, if the amount secured is Rs.100 or more.

Mortgage by Deposit of Title-Deeds, i.e., Equitable Mortgage [Section 58(f)]

Where a person in any of the following towns, namely, the towns of Calcutta, Madras and Bombay, and in any other town which the State Government concerned may, by notification in the Official Gazette, specify in this behalf (as mentioned on page 174 earlier), delivers to a creditor or his agent documents of title to immovable property, with intent to create a security thereon, the transaction is called a mortgage by deposit of title deeds. This is also known as Equitable Mortgage.

Essentials of Equitable Mortgage/Mortgage by Deposit of Title-deeds

1. There must be a debt, existing or future.
2. The mortgagor (debtor) delivers the title-deeds of the property to the mortgagee (creditor)
3. The delivery of the title-deeds must be made within the jurisdictions of the specified towns.
4. A mortgage by deposit of title-deeds does not require execution of a mortgage-deed.
5. Being an oral transaction, i.e., where no mortgage-deed is prepared, registration is not required.
6. Where deposit of title-deeds is accompanied by mortgage-deed, it must be registered.

Anomalous Mortgage

Section 58 (g) provides as follows : A mortgage which is not a simple mortgage, a mortgage by conditional sale, an usufructuary mortgage, an English mortgage or a mortgage by deposit of title-deeds within the meaning of this section is called an anomalous mortgage.

Thus, a mortgage which does not fall within any of the other five classes enumerated is called an anomalous mortgage. The combinations of the following forms are also included under the anomalous mortgage : (1) simple mortgage usufructuary (a combination of a simple mortgage and usufructuary mortgage); (2) mortgage usufructuary by conditional sale (a combination of usufructuary mortgage and a mortgage by conditional sale).

Also where there is a slight variation in the terms and conditions of any of the five classes of mortgage, the resultant mortgage will be called an anomalous mortgage.

Further, customary' mortgages arc anomalous mortgages, whose incidents arc to some extent governed by custom.

Sub-mortgage

A sub-mortgage is a mortgage of a mortgage and is executed by the mortgagee. The mortgagee further mortgages the property mortgaged with him by way of security.

If the sub-mortgagee wishes to bind the original mortgagor, he must give a notice to him. In case, the sub-mortgagee fails to give a notice of the sub-mortgage to the original mortgagor and the latter pays off the mortgagor in ignorance of the sub-mortgage, the sub-mortgagee cannot hold the original mortgagor liable.

Rights of a Mortgagor

1. Right of redemption on payment of mortgage-money when it becomes due for payment.
2. Right to require the mortgagee to transfer the mortgaged property to third party instead of re-transference to mortgagor.
3. Right to inspect and make copies or abstracts of documents of title relating to mortgaged property.
4. Right to redeem separately or simultaneously.
5. Right of usufructuary mortgagor to recover possession on mortgage having been paid off through the profits or incomes or on expiry of the stated period.
6. Right to any accession to mortgaged property.
7. Right to improvements to mortgaged property.
8. Right to have the benefit of renewed lease.
9. Right to lease the mortgaged property.

Liabilities of a Mortgagor

Mortgagor shall be liable:

1. In case mortgagor either does not have interest in the property or his power to transfer the same is restricted.
2. Where he fails to defend his title.

3. Where he fails to pay public charges.
4. Where mortgaged property is a lease and the mortgagor fails to pay rents thereon or fails to perform all conditions of the lease.
5. Where he fails to discharge prior encumbrances.
6. Liability for causing destruction of or damage to the mortgage property thereby rendering the security insufficient

Rights of a Mortgagee

1. Right to foreclosure, i.e., to obtain a degree from the court debarring the mortgagor of his right to redeem the property.
2. Right to sue for mortgage money in certain cases.
3. Right of private sale, i.e., without intervention of the court.
4. Right to appoint receiver of income of the mortgaged property.
5. Right to any accession to the mortgaged property.
6. Right to the new lease.
7. Right of mortgagee in possession to spend money for specified purposes.
8. Right to proceeds of revenue, sale or compensation on acquisition.

Liabilities of a Mortgagee

1. In the absence of a contract to the contrary, he is bound to bring one suit on several mortgages.
2. To manage the property as a person of ordinary prudence would manage his own properties.
3. To use best endeavour to collect the rents and profits thereof.
4. To pay the government revenue and all other charges of public nature.
5. To make necessary repairs.
6. Not to commit an act which is destructive or permanently injurious to the property.
7. To apply fire-insurance claim in re-instatement of the property or reduction of mortgage-money.
8. To keep clear, full and accurate accounts of all sums received and spent by him.
9. To indemnify any loss occasioned by his default.

UNIT-III

GUARANTEES

GUARANTEES

Guarantee is yet another method of securing banker's advances to the customers. Where a borrower has no tangible securities to offer or the value of such securities is insufficient to cover the loan amount, the banker may ask his customer to provide a 'guarantee' for the repayment of the loan. ‘Guarantee’ observes J. M. Holden, means "when a guarantor signs a guarantee in favour of a banker, he is saying in effect 'advance money, to your customer, Mr. X", and if he does not repay, I will be responsible". A guarantee, therefore is the personal security of a third person.

Definition

A contract of guarantee is defined by the Indian Contract Act as "A contract to perform the promise, or discharge the liability of a third person in case of his default." The person who gives the guarantee is called the ‘Surety’ the person for whom the guarantee is given is called the 'Principal Debtor’, and the person to whom the guarantee is given is called the ‘Creditor’. In India, a contract of guarantee may be either oral or in writing, but under English Law it must be in writing. In English Law, a guarantee defined as a "promise made by one person to another to be collaterally answerable for the debt, default or miscarriage of a third person and must be evidence in writing."

From the above discussion it is clear that in a contract of guarantee there must be two contracts, a principal contract between the principal debtor and the creditor, and a secondary contract between the creditor and the surety. In a contract of guarantee there are three parties, viz., the creditor, the principal debtor and the surety. So, when A requests B to lend Rs.10,000 to C, and guarantees that C will repay the amount within the agreed time, and that on C’s failing to do so, he will himself pay to B, there is a contract of guarantee.

It needs to be noted here that the contract of surety is not contract collateral to the contract of the principal debtor, but is an independent contract. It is not necessary that the principal contract, between the debtor and creditor, must exist at the time the contract of guarantee is made; the original contract between the debtor and creditor may be about to come into existence. Similarly, under certain circumstances, a surety may be called upon to pay though principal debtor is not liable at all. For instance, in a case where principal debtor is a minor, contract cannot be enforced against him but surety continues to be liable.

Fiduciary Relationship : A contract of guarantee is not a contract uberrimae fidei (requiring utmost good faith). Nevertheless, the suretyship relation is one of trust and confidence, and the validity of the contract depends upon good faith on the part of the creditor. A creditor must disclose all those facts which under the circumstances, the surety would expect not to exist. So, where a guarantee is given for good conduct of an employee, the employers'

failure to inform the surety of any breach on the part of employee, will discharge the surety.

Contract of Indemnity : A contract of indemnity appears to be analogous to a contract of guarantee but actually the two are different. A contract of indemnity is defined by Section 124 of the Indian Contract Act, as a "contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person." The person who promises or undertakes to indemnify the loss is called 'Indemnifier' and the promisee, or the one whose loss is made good is called the 'Indemnified'. So, where A indemnifies B against the consequences of any proceedings which C may take against B in respect of a certain sum of Rs.200, a contract of indemnity arises.

According to the above definition the loss to be made good must have been caused either by the conduct of the promisor himself, or by the conduct of any other person. So, losses caused by accident or by the conduct of the promisee himself are not covered. If this strict view is accepted, a large number of insurance contracts will have to be excluded. Therefore, the Indian courts have applied the English equitable principles to contracts of indemnity.

Distinction between Contract of Guarantee and a Contract of Indemnity

1. The liability of a promisor is primary and independent in a contract of indemnity. In a contract of guarantee, the liability is secondary, the primary liability being that of the principal debtor.
2. In the case of guarantee, there is an existing debt or obligation, the performance of which is guaranteed by surety. In case of indemnity the possibility of any loss happening is a contingency against which the indemnifier undertakes to indemnify
3. In a contract of guarantee, after discharging the debt, the surety is entitled to proceed against the principal debtor in his own name; in case of indemnity, the indemnifier cannot proceed against third parties in his own name, unless there is an assignment

RIGHTS AND OBLIGATIONS OF THE BANKER

Rights

1. The liability of the surety cannot be postponed till all other remedies against the principal debtor have been exhausted. The banker is entitled to demand payment from the surety as soon as the principal debtor refuses to pay or makes a default in payment.

The banker also has a right of general lien on the securities of the surety in his possession. This right, however, arises only when the principal debtor has made default and not before that.

2. Where surety is insolvent, the banker is entitled to proceed in the surety's insolvency and claim the pro-rata dividend.

Obligations (Liabilities)

Indian Contract Act, 1872 imposes the following obligations on a banker, as a creditor in a contract of guarantee:

a. **Not to change any terms of the original contract:** The banker should not change any term of the original contract without seeking the consent of the surety.

b. **Not to release or discharge the principal debtor:** The banker is under an obligation not to release or discharge the principal debtor.

2. Not to compound, or give time to, or agree not to sue the principal debtor.
3. Not to do any act inconsistent with the rights of the surety
4. **Not to conceal material facts (Section 140):** Any guarantee which the creditor obtains by means of keeping silence as to material circumstances is invalid.

Rights of Surety

Rights of a surety may be classified under three heads :

(1) Rights against the creditor,

(2) Rights against the principal debtor, and

(3) Rights against co-sureties.

(1) Rights against the creditor

In case of fidelity guarantee, the surety can direct the creditor to dismiss the employee whose honesty he has guaranteed, in the event of proved dishonesty of the employee. The creditor's failure to do so will exonerate surety from his liability.

(2) Rights against the principal debtor

(a) Right of subrogation. Section 140 of the Contract Act lays down that where a surety has paid the guaranteed debt on its becoming due or has performed the guaranteed duty, on the default of the principal debtor, he is invested with all the rights which the creditor had against the debtor.

(b) Right to be indemnified. The surety has the right to recover from in the principal debtor, the amounts which he has rightfully paid under the contract guarantee.

(3) Rights against co-sureties

Right of contribution. Where a debt has been guaranteed by more than one person, they are called as co-sureties. Section 146 provides for a right of contribution between them. When a surety has paid more than his share of the debt or a decree has been passed against him for more than his share, he has right of contribution from the other sureties who are equally bound with him.

Discharge of Surety : A surety is discharged of his liabilities in the following cases:

1. If the creditor discharges the principal debtor or acts in a manner the sequence of which is to discharge the principal debtor. The liability of surety is only secondary and co-extensive with that of the principal debtor. Surety can never be held liable for an amount more than the principal debtor is liable for. Thus, as the discharge of the principal debtor extinguishes his (debtor's) liability, the contract of guarantee also ipso facto ceases to exist.
2. If the creditor, without the consent of the surety, make composition with, or promises to give time or not to sue the debtor.
3. If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do and thereby the eventual remedy of the surety against the principal debtor is impaired.

Precautions to be taken by a Banker

A banker, while advancing money against a guarantee, should take the following precautions :

1. The credit worthiness of the guarantor must be the primary consideration. "The security behind a guarantee", says Jones in his 'Studies in practical Banking' “Is the instant ability of the guarantor to pay, when called upon." Hence, the banker should assess not only the financial standing of the guarantor but should also enquire into his honesty and integrity. The financial standing of the surety may be assessed by studying his financial standing statements. To study the honesty and integrity, banker should ask for his previous and present bankers and make enquiries from them.
2. Periodical reports on the financial standing of the borrower as well as the guarantor should be obtained and wherever the advance is considered endangered all further transactions be stopped.
3. The guarantee agreement should be signed in the presence of an officer of the bank. This should be done to exclude any possibility of guarantor's signatures being forged.
4. In case more than one person are to stand as sureties, no advance should be given until and unless all such sureties have signed the guarantee agreement.
5. The guarantee agreement should be very carefully drawn to contain all the terms of the guarantee in a comprehensive manner. Further, the agreement should be stamped as per the provisions of the Indian Stamp Act.
6. In the event of the death, lunacy or insolvency of the principal debtor or guarantor, or on receipt of notice of revocation of guarantee, the account should be broken so as to avoid the application of the rule in Clayton's case.
7. As far as possible, a banker should insist on tangible assets being delivered to him as security along with guarantee.

UNIT-IV

PROJECT APPRAISAL BY FINANCIAL INSTITUTIONS

INTRODUCTION

Assessing the viability or feasibility of a proposed project by the lending institutions is called project appraisal.

Generally, commercial banks cannot finance on a long term basis to industries as most of their funds are short term in nature. In the case of term loans, the bank provides them on the basis of the purpose and they differ from short term loans. Term loans are not only huge but they are given for a longer period and there are greater risks involved. But, the earnings of the banker will be more which compensates for the loss. The borrowing industry is able to utilise the-term loans in a much better manner and it improves their production capacity, earnings and utilisation of existing capacity.

While providing term loans, the lending institutions will have to find that the income received from the utilisation of these loans by the borrower firm is sufficiently large that they are able to repay the loan. A banker has to assess the project for which the loan is required. He must make sure that the project will provide enough contribution so that the loan could be repaid. An appraisal made by a banker on the viability of the project from the point of repayment is known as project appraisal. The problem for the banker will be more when there are different projects with different rates of return. It is here that the bank has to adopt a technique and go in for the selection of a suitable project.

Four major criteria in project appraisal

There are four major criteria which have to be studied in project appraisal to ascertain its feasibility. They are:

(1) Technical feasibility
(2) Economic feasibility
(3) Financial feasibility
(4) Managerial feasibility

(1) TECHNICAL FEASIBILITY

i. To find out whether the various factors of production are available,
ii. Suitable location of the project.
iii. Adopting appropriate technology,
iv. Providing suitable training to manpower,
v. Erection of plant and equipment,
vi. Technical know-how.
vii. Suitable plant lay-out.
viii. Clearance for pollution from the pollution control board,
ix. Environment clearance under Environment Protection Act.
x. Protection under the Patent Right and Trademark Act.

xi. Disposal of wastage.

(2) ECONOMIC FEASIBILITY

i. Market share of the product,

ii. Demand for the product,

iii. Competition prevailing in the market,

iv. Product life cycle and stage of the product,

v. Future demand of the product.

vi. Fulfilment of social objectives such as employment generation, development of backward areas, etc.

vii. Scope for the product [Strength, Weakness Opportunity and Threat (SWOT Analysis)].

(3) FINANCIAL FEASIBILITY

i. Financial soundness of the project which is based on return on investment.

ii. Various sources of finance available and their costs.

iii. Expected cash inflow and outflow.

iv. Cost of the project.

v. Profit margin.

vi. Cost of production,

vii. Future growth of the project,

viii. Gross and net earnings.

ix. Future prospects.

(4) MANAGERIAL FEASIBILITY

(i) Competence of the Board,

(ii) Experience of the staff,

(iii) Technical competence.

(iv) Problems that are likely to be encounted in industrial relations,

(v) Experience in the field.

STEPS INVOLVED IN TERM LENDING

The following are the steps involved while lending term loan to a borrower by the banker. They are:

1. Interview with borrower
2. Obtaining information about the borrower
3. Based on the information furnished, assessing the credit worthiness of the borrower

4. In addition to these, the following information will be obtained by the banker:

   (a) Details about the industrial establishment

   (b) Means of finance adopted

   (c) Cost of the project

   (d)Arrangements for marketing of products

   (e) Licence formalities

   (f) Pollution clearance

   (g) Profitability and cash flow

6. Statements to be accompanied along with project
7. Estimate of cost of production
8. Estimated production and sales
9. Cash flow statement
10. Estimates of cost of project
11. Method of financing
12. Previous years' performance
13. Loan amount and the period of repayment
14. Security that is offered
15. Scrutinising the particulars
16. Arriving at a critical analysis of the borrower
17. Collection of data of a borrower
18. Fixing repayment schedule, rate of interest, and instalment amount, etc
19. Documentation of above details
20. Releasing of the loan amount
21. Post-sanction inspection

When a banker is appraising project, he takes into account four broad accepted which are

(a) Financial,

(b) Technical,

(c) Economical; and

(d) Managerial

SWOT Analysis

In addition to these, the banking company will also look into the borrowing concern's strength, weakness, opportunity and threat. It is called SWOT Analysis.

Strength:

The bank will take into account, the strength the borrower, from the point of view project and its advantages over others. The borrower's technical competence is also a strong factor.

Weakness:

Competition, economic condition, obsolescence of the product/project.

Opportunity :

Emergence of new markets, increasing purchasing power of the consumers new use for the products; and expansion of the project.

Threat:

Threat due to non-availability of raw material, labour, substitutes, are these factors are taken into account before finishing a project.

APPRAISAL BY THE BANKER

Capital is very scarce and a dear resource. It should be put to optimum use. Project appraisal may be explained as a detailed and a critical evaluation of the project to determine the earning capacity and the future proposals of the project. This can be studied with the help of four broad aspects of appraisal. They are:

(1) **Financial Feasibility:** The project under study should be financially viable. For which the following aspects should be given importance.

(a) **Cost of the project:** A critical review of the cost estimates of the project is necessary. The estimates should be realistic and flexible to some extent. It should be generally acceptable as a sound financial proposition. The various sources of finance available, and to the extent it is available and required should also be studied. The various sources of finance are

(1) Share capital	-	Amount contributed by the share- holders
(2) Reserves and surplus	-	Appropriation from past profits may be available in case of successful units.
(3)Retained earnings	-	A prudent management would build up reserves in the name of depreciation, development reserves, dividend equalisation reserve, etc. which can be used in the business
(4)Long-term borrowings	-	Nature of the long-term borrowings composition, both existing and proposed to

		assess the interest payable, principal amount payable and the surplus available.
(5) Deferred payments	-	In case of imported item, the industrial units are allowed to settle the dues on deferred payment terms. To some extent, these facilities easy the financing problems as payments are made in easy installments
(6) Other sources	-	Loans from directors, friends, private sources, and short term creditors to some extent

(b)Cost of production and profitability: The next study is to ascertain the earning capacity of the project. For this purpose, it is necessary to whether the unit is in a position to manufacture the products/proposed products at a reasonable cost and sell them at a price which would leave adequate margin in a competitive market. The borrower may under estimate the cost and over estimate the selling price. So the banker should look into all the aspects of cost and the current market prices and also the demand for the product.

(c) Cash-flow estimates: The lending banker must ascertain the dates when the project would need funds for different purposes and various sources from which such funds would be available. This ensures sound financial planning and availability of required cash to meet the expenses. Profitability alone is not sufficient for the banker. The actual cash inflow and outflow matters a lot as the repayment schedules will be worked out based On cash inflow and outflow only. For this, the cash flow estimates are being used by the banker showing the various sources of finance and application of funds. The cash flow estimates help the banker to ascertain.

1. The probable income and expenditure of the project during the loan period.
2. Whether the unit will have sufficient cash inflow to repay the loan and the interest amount.
3. The nature of instructions to be imposed by the lender as far the utilisation of funds are concerned, if necessary.

(d)Proforma Balance Sheets: In case of new units, the borrower should asked to submit the proforma balance sheets for the next 3 years. In case of the existing units, balance sheets of the preceding five years should be studied properly to judge the solvency and liquidity position. The profitability ratios are also worked out and a link between the cash-flow statements and these ratios is arrived at to see whether the unit's working will be in accordance with the forecasts. Various ratios are being worked out as follows:

Profitability tests	-	Net profit to sales, Net profit to capital employed, Return on equity capital, employed Interest Coverage ratio, Debt service coverage ratio.
Solvency tests	-	Debt-equity ratio, Long-term debt to capital ratio, Net return ratio.
Liquidity tests	-	Current ratio, Quick ratio/Acid test ratio, Debtors turnover ratio, Creditors turnover ratio, Stock turnover ratio.

(2) Technical Feasibility: This implies the assessment of various requirements of actual production process. It includes the detailed estimate of all the goods and services needed for the project. (Example: land, buildings, transportation facility, raw materials, fuel, power, water, etc.). In case of import of raw materials, government policy regarding the same should also be studied. The banker should pay special attention to the following aspects:

1. Feasibility of the technical process selected and its suitability under Indian conditions.
2. The location of the project to verify the availability of various factors of production like water, power, fuel, labour, raw materials, storage facility, transportation, etc.
3. Specification of plant and equipments Conditions of the existing plant and machinery must be assessed. In case of new machinery, the banker should ensure that the cost of the equipment is based on quotations from suppliers of standing and that adequate provisions have been made for spare parts, freight, insurance and servicing facilities.
4. Arrangements for securing the technical know-how and training of personnel and labour. For some projects, foreign experts or foreign training of local staff may be essential. This should also be considered by the banker while appraising the project.
5. Land and buildings - Whether the land acquired would be sufficient having regard to the future requirements. In case of lease hold property, the terms and condition of lease should be carefully studied.
6. Facilities for the disposal of effluents and also of the by-products and the construction schedule.

(3) Economic feasibility and social aspects: The proper repayment of the borrowings depends upon the earning capacity of the business. It has to be determined as to how much of the output could be absorbed in the market at given prices. This can be done by taking into account the prevailing demand and supply position. The study should go beyond immediate future possible changes in the volume and pattern of supply and demand. Factors like price control, shortage of raw materials, power position, obsolescence of machinery, possibility

of increased competition should be carefully examined. If the product is oriented to an export market, prevailing conditions in the foreign market should also be analysed.

The banker should examine as to whether project will find a useful place in the economy and will also be a satisfactory one from the marketability point of view. The employment potential, the capacity to create a climate of industrialisation and the stimulus it will provide for the growth of ancillary industries should also be considered.

(4) Managerial competence: The utilisation of the loan amount, the repayment prospects of the loan depends on the competence of the management of the borrowing unit. All the factors of production and other facilities would go as a waste if the management is not efficient. The management should consist of competent and experienced directors and the board should be a broad-based one. The unit should also have qualified technical and administrative personnel with experience.

The banker after going through the proposal should view the situation as a whole. The strength of one aspect of the proposal may outweigh the Weakness of another aspect. Equal importance has to be given to all the aspects of appraisal. If the negative factors predominate, the proposal be better declined

PRE SANCTION INSPECTION

Subsequent to the completion of the preliminary data, if the banker is satisfied about the proposal, he must carry out an inspection of the unit to verify the correctness of the information. Investigation should be made wherever necessary. Physical inspection of the assets should be made. Valuation of the Stock should be verified by the banker to see whether there is any overvaluation or undervaluation. The banker should also see as to whether all the liabilities and claims have been disclosed properly by the borrower.

COLLECTION OF CREDIT INFORMATION

The bankers have to collect information regarding the prospective borrower through the outside sources also, apart from the statements given by the borrower himself. The banker can collect the credit information through the following sources:

1. Credit information bureau-about the borrower taking secured loans of Rs. 10 lakhs and more
2. Through the bank references
3. The banks may make enquiries from business and dealers in the market about the credit worthiness of a customer.

POST SANCTION INSPECTION

The banker's responsibility does not end up with the sanctioning of the loan. The banker should verify the end use of the loan. For this, post-sanction inspection should be conducted regarding the following:

1. Actual use of the loan to see whether it has been used for the purpose for which it was originally sanctioned.
2. Whether the borrower is stipulating to all the terms and conditions of the loan agreement.
3. The progress in the project and whether it correlates with the estimates and if there is any variation, the reasons for the same should also be notified.
4. The existence and maintenance of the security. The value of the security should be ascertained at periodic intervals. Any adverse changes be carefully noted and steps taken to secure the advances.
5. Verification of the inventory - From the balance sheet and also the stock registers, the banker should verify the level of inventory and also the financial position of the unit.
6. If any default is made by the borrower in the repayment of the loan, reasons for the same should be ascertained and steps to rectify the same should also be initiated.
7. Care should be taken to ensure that all stocks and properties of the borrower are insured fully and insurance premium is paid regularly.
8. Production and sales record should be compared with the stock level and inventory level.

Collection from debtors and payment to creditors should also be verified to ensure smooth working of the unit. If the banker notices any deviation, he may nominate a person of his confidence on the board of directors of the borrowing concern to rectify matters.

THE BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The Basle Committee on Banking Supervision, in April 1997, released the Basle Core Principles for Effective Banking Supervision. a set of twenty-five basic Principles which it advocates for a supervisory system to be effective. The Basle Core Principles have been drawn up by the Basle Committee in close consultation with the supervisory authorities in fifteen emerging market countries The 25 Core Principles represent the basic elements of an effective supervisory system and cover pre-conditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. These principles are in the nature of minimum requirements.

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions. The principles are minimum requirements and in many cases may have to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large. The twenty-five Core Principles are set out below.

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.
3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.
4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

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.

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. 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.

8. 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 exposures to single borrowers or groups of related borrowers.

10. In order 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.

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.

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.

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 risks and, where appropriate, to hold capital against these risks.

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.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules, that promote high ethical and professional standards in the financial

sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.
19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintained adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain, a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking

23. Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
25. Banking supervisors must require the local operations of foreign banks

to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The South-East Asian Crisis has revealed the necessity of adequate and effective supervision of financial intermediaries in the course of financial sector reforms. It is increasingly recognized that the implementation of these 25 core principles would have certainly lessened the severity and cost of the South-East Asian crisis.

UNIT-IV

MANAGEMENT OF NON-PERFORMING ASSETS (NPAS)

NP As are an inevitable burden on the banking industry. Banks need to monitor standard assets to arrest any account becoming a NP A. Today, the success of bank depends upon the methods of managing NP As and keeping them within a tolerance level.

Factors contributing to NP As

According to a recent study conducted by the RBI, the underlying reasons for NP As in India can be classified into two heads, namely:

(i) Internal Factors

(ii) External Factors

Internal Factors

The following internal factors contribute to NP A in the orger of prominence:

a. Diversion of funds for expansion / diversification / modernization or for taking up new projects.

b. Diversion of funds for"assisting or promoting associate concerns.

c. Time or cost overrun during the project implementation stage.

d. Business failures due to product failure, failure in marketing etc.

e. Inefficiency in management.

f. Slackness in credit management and monitoring.

g. Inappropriate technology or problems related to modem technology.

External Factors

The external factors that contribute to NP A's are the following:

1. Recession in the economy as a whole
2. Input or power shortage
3. Price escalation of inputs
4. Exchange rate fluctuation
5. Accidents and natural calamities
6. Changes in Government policies relating to excise and import **duties,** pollution control orders etc.
7. Government loan waiver scheme

Other Factors

Apart from the above factors, there are certain other factors which are responsible for standard assets becoming NP As. They are the following:

(a) Liberalisation of the economy and the consequent pressures from liberalisation like severe competition, reduction of tariffs, removal of

restriction etc.

(b) Poor monitoring of credits and the failure to recognize early warnmg, signals shown by standard assets.

(c) Promoters' over Optimism in setting up large projects.

(d) Sudden crashing of capital markets and the failure to raise adequate funds.

(e) Granting of loans of certain sectors on the basis of Govermnent's directives rather than commercial imperatives.

(f) Mismatch of funding, i.e., using loans granted for short-tenns for long-tenn transactions.

(g) High leveraging and high cost of borrowing.

(h) Commitment of wilful defaults sensing that the legal recourse available to collect debts is very slow.

Early Warning Signals

The Early Warning Signals (EWS) are those which clearly indicate or show some signs of credit deterioration in the loan account. They indicate the potential problems involved in the accounts so that remedial action can be initiated immediately. In fact most banks have Early Warning Systems (EWS) for identification of potential NPAs.

Classification of Early Warning Signals -

The Early Warning Signals can be broadly classified into five broad categories as given below:

(a) Financial Signals

(b) Operational Signals

(c) Banking Signals

(d) Managerial Signals

(e) External Signals

Financial Warning Signals

Some of the financial warning signals are:

(a) Default in repayment

(b) Continuous irregularity in the account

(c) Development of L/C or invocation of guarantees

(d) Deterioration in working capital position or in liquidity

(e) Declining sales compared to previous period

(f) Substantial increase in long-term debts in relation to equal

(g) Raising sales but falling profits

(h) Incurring operating losses or net losses

(i) Raising level of bad debt losses

Operational Warning Signals

The operational warning signals are:

(a) Underutilization of plant capacity

(b) Non-payment of electricity, wages etc.

(c) Frequent labour problems

d) Poor diversification and frequent changes in plan for expansion or diversification or modernization

(e) Evidence of overstocking and aged inventory

(f) Loss of important customers

Managerial Warning Signals

The managerial Warning Signals relate to:

(a) Diversion of funds and poor financial controls

(b) Lack of cooperation from key personnel

(c) Change in Management or ownership pattern or key personnel

(d) Undertaking of undue risks

(y) Fudging of financial statements

Banking Signals

Banking related Warning Signals are:

(a) Frequent request for further loans

(b) Delays in servicing of interest

(c) Reduction of operations in the account or reduction of bank balances

(d) Opening of accounts with other banks

(e) Dishonour of cheques or return of bills sent for collection

(f) Not routing sales transactions through the account

(g) Delays in submitting stock statements and other data or Non-submission of periodical statements

(h) Frequent excesses in the account

External Warning Signals

Signals relating to external factors are:

(a) Economic recession

(b) Introduction of new technology

(c) Changes in Government policies

(d) Emergence of new competition

(e) Natural Calamities

(f) Weakening of industry characteristics

Management of NP As

To ensure long-term profitability, banks have to manage NPAs effectively by adopting the following techniques:

(a) Insuring that loans are diversified across several customer segments.

(b) Introducing robust risk scoring techniques to ensure better quality of loans.

(c) Improving the quality of credit mentioning system by designating a separate credit manager or relationship manager for that purpose.

(d) Raising the share of non-fund income by increasing service, product offerings by better use of technology.

(e) Reducing operating expenses by upgrading the banking technology.

(f) Monitoring early warning signals and taking immediate appropriate remedial action.

(g) Adopting credit rating system to identify, measure and monitor the credit risk of individual proposal.

(h) Putting certain borrowal accounts which exhibit certain distress signals under watch list and paying a close and special attention so that they may not 'become NPA.

(i) Reducing the impact of operational risks by measuring them and mitigating or insuring them.

(j) Knowing a clients profile thoroughly and preparing a credit report by paying frequent visits to the client and his business unit,

(k) Appraising credit proposals professionally and insisting on timely delivery of credit.

Remedies Available

In spite of better credit management in terms of appraising and monitoring of loan assets NP As do occur. In such cases, various remedial measures are available to deal with such NPAs. The remedies may be broadly divided into two namely:

(i) Non-legal remedies

(ii) Legal remedies

Non-legal Remedies

Non-legal remedies may be in the form of compromise, mergers and takeovers. The goods pledged or hypothecated may be sold without the intervention of the court. The debts can be assigned in favour of an agency which may come forward to collect debts for a service charge.

Legal Remedies

The RBI has advised lenders to initiate legal measure including criminal actions. Some of the important legal measures available are:

(a) Filing of civil suits for the recovery of debts or for the enforcement of the security.

(b) Filing of suits under State Recovery Acts for the recovery of debts.

(c) Referring the cases to Debt Recovery Tribunals (DRTs) and Debt Recovery Appellate Tribunal (DRAT) set up under the Recovery of Debts due to Banks and Financial Institutions Act, 1993.

(d) Referring cases to Lokadalats constituted under the Legal Services Authorities Act, 1987 which helps in resolving disputes between the parties by conciliation, mediation, compromise or amicable settlement. Every

award of the Lokadalat shall be deemed to be a decree of a civil court

(e) Resolving large loans via debt recovery mechanisms, most notably the Corporate Debt Restructuring (CDR) mechanism. One Time settlement schemes have been tried with good results.

(f) Proceeding against the default borrower under the securitisation and

Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI ACT) 2002 which came into effect on June 21,2002. Under the Act, banks and financial institutions are allowed to issue demand notices to defaulting borrowers and to take possession of the secured asset without the intervention of the courts, if the dues are not paid within 60 days from the date of such notice. The provisions of this Act are not applicable to unsecured loans or loans below Rs. 1,00,000/- or to loans due is less than 20% of the principal amount and interest thereon.

Recently on April 8, 2004 the supreme court has upheld the validity of the securitisation Act by giving one major relief to the borrower-litigant. The earlier provision that the borrower will have to deposit 75% of the disputed amount before appealing has been scrapped. With the implementation of the SRFAESI Act, many lenders have commenced their recovery action against recalcitrant debtors. Since the supreme court has upheld the constitutional validity of the Act, it will go a long way in managing NPAs successfully. This Act also provides the formal legal basis for setting up Asset Reconstruction Companies (ARCs) in India.

UNIT V
DOCUMENTATION

Correct documentation is essential from the point of view of the safety of an advance. Documents should be correctly drafted and stamped, properly executed and necessary legal formalities, if any, complied with. For example, the charge with the Registrar of Assurances and/or the Registrar of Companies, if necessary, should be registered within the prescribed time. In case the advance is on a secured basis, the document should effectively create the required charge on the security. In case of a clean advance repayable on demand, a promissory note has to be taken. If the advance has to be guaranteed, the requisite letter or deed of guarantee should be executed by the guarantor/so If at any time the filing of a suit against the borrower becomes necessary, the court may not pass a decree if the documents are detective and the bank may lose the case. The Bank may also lose the security if a valid charge there on has not been created in its favour.

Documentation forms a permanent record of the rights and liabilities inter se the parties-the bank, the borrower and the guarantor, if any. In case of a borrower's death, his heirs and successors hold the assets left by him, subject to any charge or liability that he may have created thereon. Nothing is a better proof in this regard than the documents that the deceased had executed.

It is, therefore, not only desirable but also essential that bank officials should be conversant with the law and practice on the subject.

Executants: The party executing a document must be competent to contract. A minor, a lunatic or an insolvent has no contractual capacity. A company cannot transgress or overstep the powers which it may have under its memorandum of association. All acts done by the company beyond its powers would be ultia vires the company and not legally binding on it.

Power of attorney: In case documents have to be executed by an attorney on behalf of his principal, the original power of attorney must be examined to ensure that it has been properly executed and that it confers the requisite powers on the attorney to execute the documents and bind the principal. The power to execute the documents may not be accompanied by the powers to borrow or pledge securities

Types of powers of attorney: Special Power of Attorney and General Power of Attorney. The Special Power of Attorney is confined to a single transaction. A General Power of Attorney gives a general authority and authorises the attorney to act in more than one transaction. It is intended to operate over a length of time. A power of attorney must be operative, i.e. it should not have been cancelled or revoked.

A power of attorney, except when it is irrevocable, may at any time be revoked by the principal after giving reasonable\notice. For all intents and purposes, a power of attorney is revoked by the death or mental incapacity, say, lunacy of either the principal or the attorney, or by the principal being adjudicated an insolvent (Section 201 of the Indian Contract Act, 1872). In

case, however, the authority has been partly exercised, the principal cannot revoke the authority, so far as regards such acts and obligations that have arisen from acts already done in the agency (Section 204 of the Indian Contract Act). If the power of attorney is irrevocable, it cannot be revoked or terminated by the death or insanity of the customer.

If the borrower is a company and the documents have to be executed by a director or any other official, the bank should examine the relative resolution to see that it is in order in every respect~If the executant holds a power of attorney, it must be properly scrutinised. It should also be ascertained whether the person executing the power of attorney had authority it to do so on behalf of the company. In case of a firm, documents must be signed by all partners in their personal capacity as well as their as partners.

A typed/photostat/ printed copy of the power of attorney, certified as true by the borrower, must be kept on bank's record.

Execution of documents: A document must be executed in the presence of the Agent/Accountant or any other responsible bank official. The parties should sign (not initial) according to their usual specimen signature. If a document consists of a number of pages, all the pages should be signed (not initialled) by the executants.

When any amendment or change has to be made in any of the conditions or terms of lending, say, by way of enhancement or reduction in the limit or the nature of security, a supplemental agreement has sometimes to be drawn up, giving reference to the original agreement. Such a step may even be essential in certain cases to avoid payment of stamp duty over again, particularly when it is very heavy or to prevent any break in continuity, so that claim/s of any intervening creditor/s is/ are obviated. For example, if a limit is enhanced or further facility is allowed on the basis of an existing simple mortgage, the supplemental agreement would be much preferable to a fresh agreement, to obtain the said two objectives. The same formalities regarding execution, stamping, registration, etc. have to be observed as in the case of the original agreement.

As far as possible, there should be no cutting, deletion, interlineation or overwriting in the documents. In case, however, there is a cutting, etc. the executant/s must authenticate it under his/their full signature/so The chances of cuttings, overwritings, etc. are eliminated if draft of the documents is prepared in the first instance. The schedule of securities accompanying the documents should also be signed in full by the borrower/so

In case of a borrower who is illiterate, the contents of the document/s must be explained to him, in the language which he understands, by a lawyer or any other respectable person, preferably one not on the staff of the bank. The person concerned (stating his name and address), should give a certificate duly signed by him in this regard. The certificate should further state that the borrower is known to him or has been properly introduced to him and has affixed his thumb impression on the document/s, say, pronote, letter of guarantee of his own free will, without any undue influence or coercion and

after understanding the terms and conditions of the documents. The date on the document/s and the certificate should be the same. The certificate should be tagged with the security documents and carefully preserved.

No operation on ah overdraft, cash credit or other advance account should be permitted until all the requisite documents are properly and duly executed by all the parties concerned, including the guarantors.

Bank's printed forms: All banks have prescribed security forms for various types of advances. These forms are drafted by the bank's solicitors/lawyer and it may be presumed that proper care has been taken by them to legally safeguard the bank's interests in all respects. Any deviation from the standard form should not be permitted without obtaining the requisite permission from the Central Office. For the guidance of branches, banks circularise the set of forms to be taken in any particular type of advance.

Contents of document: The terms and conditions of the advance, agreed upon between the borrower and the lending bank, must be clear, definite and unambiguous. The document should be drafted in technical language, commonly adopted for the purpose. Many technical terms have received judicial interpretation and the bank treads on safe ground while using such terms instead of its own terms which might be interpreted in a sense different from what was intended. The document must, mention the correct names of the parties, contain proper recitals, give a detailed description of the security, if any, to be charged, the consideration, rate of interest, terms of repayment, other important conditions agreed to and the testimonium clause. The testimonium clause is the concluding portion of the deed which generally reads as: "In witness whereof the said parties hereto have set their respective hands the ... day of month and year above written."

Mortgage deed: If there is a legal mortgage of immovable property, the document must mention the names of the borrower and the lending bank, so as to sufficiently identify both. There will be a stipulation in the deed / that the borrower is the owner of the property, has clear title to it and the property is unencumbered. If the mortgaged property consists of a bungalow, the deed must state the fact as such, whether it is single storeyed or double storeyed, the area of the site under the bungalow, its situation; boundaries, municipal number, etc. The mortgagor must hand over to the bank all the title deeds including the last conveyance· deed in his favour. The plan of the property duly signed by the borrower should form an enclosure to the deed. The amount of the loan, the rate of interest and the terms of repayment must be mentioned. The document must also contain an authority from the borrower to the bank to arrange for insurance, inspection and repairs of the property, as and when necessary, at borrower's cost, and that the mortgaged property would be charged for the expenses incurred by the bank for such insurance, inspection/repair, etc. as may be arranged by the bank. The deed will contain a clause about the right of the bank to proceed against the borrower for the recovery of the debt, including interest and incidental charges, and have the property sold (through court). The borrower also makes himself liable

personally for any shortfall. Other terms and conditions as mutually agreed upon may also be included.

The mortgage deed is required by law to be attested by at least two witnesses. In the absence of such attestation, the document is void and not enforceable. After execution of the mortgage deed, it must be registered with the Sub-Registrar of Assurances within four months of its execution. Under Section 25 of the Indian Registration Act, 1908, if owing to urgent necessity or unavoidable accident, any document is not presented for registration within four months of its execution, the Registar (not the Sub-Registar) may allow its registration, provided the delay in presentation does not exceed ten ' times the amount of the registration fee can be levied by the Registar. It is, however, adyisable to get the deed registered, as early as may be possible, after it is executed.

Cash Credit-Pledge: In case of a cash credit account secured by pledge of goods, the document will mention the names of the parties (the borrower and the lending bank), the maximum limit of borrowing, the security, the rate of interest-ordinarily linked to the Bank Rate-and the margin to be maintained. The document will confer on the bank the right to verify and inspect the goods, appoint godown keepers at borrower's cost, have the security adequately insured against specified risks and an authority to receive the monies from the insurance company in the event of a claim. The bank is also authorised to apply any excess amount after adjusting the debit balance in the account to the borrower's other debit accounts with the bank. The' borrower specifically agrees to the bank's right of set-off against any credit balance lying in any other account in his name.

One of the clauses in the document assures the bank that the borrower has absolute title to the security, or such interest therein as entitles him to pledge it, that the security is not previously encumbered, and that he would not create any other charge thereon during the continuance of the advance. He will be responsible to keep the security in proper condition both in regard to quality and quantity. The bank is also specifically authorised at its discretion to get the goods verified and valued at the expense of the borrower. Further, the agreement gives a right to the bank to demand repayment of the loan by giving a reasonable notice. The bank will further have the right to sell the security by private sale or public auction at its discretion, after giving th, borrower reasonable notice of sale of the security. In the event of the security being insufficient, the debtor agrees with the bank to make himself personally liable. He also undertakes to furnish and verify the returns and statements from time to time.

The agreement also contains a 'continuing security' clause that the cash credit arrangement will not come to an end even if the account is in credit at any time. The continuance of the liability of the borrower/s under the letter of pledge is also provided despite any change that may take place in the constitution of the firm or its members.

Cash credit-hypothecation: The possession of the security hypothecated to the bank remains with the borrower. The document specifically mentions the bank's equitable charge on the security and the boffower's responsibility for its proper upkeep. Consequently, appropriate clauses are incorporated in the docmpent to make this position clear and succinct. Most of the provisions in the document are otherwise more or less the same as in the document of pledge. There is, however, another important condition stipulated in the hypothecation agreement that the lending bank may, at its discretion, take possession of the stocks from the borrower, and convert the hypothecation account into a pledge account. Such possession is not usually taken without the consent of the borrower, since any forcible attempt to seize the goods may result in a number of complications.

Balance confirmation letters: Balance confirmation / acknowledgement letters and confirmation letters. of securities, if any, held in an advance account, must be obtained ordinarily once in a half year/year, according to the practice of the bank. Such acknowledgements must be signed by the borrwer/s across an appropriate revenue stamp to make "them valid. Some banks insist on separate acknowledgements of the same debt, if the number of borrowers is more than one in anyone account. For example, in a joint or partnership account, each one of the joint borrowers or the partners, as the case may be, has to confirm the balance.

Letter of guarantee: If a Partnership firm has to guarantee an advance, the guarantee letter or deed must be signed by all the partners for and on behalf of the firm and also in their personal capacities.

In case an advance has to be guaranteed by the director of a company some banks have the demand promissory note signed by the favour of the directors arid endorsed by them jointly and severally in favour of the bank. With some other banks the practice is to have the letter of guarantee signed by the directors in their personal capacities.

Stamps: After having decided the documents which have to be executed by the borrower, the bank should ensure that they bear the correct stamps. In case of doubt, Bank's legal department/legal adviser should be consulted. It may also be stated that under Section 31 of the Indian Stamps Act, 1899, the Collector can be approached for determination of the correct stamp duty on any instrument. It may, however, mean delay. Section 17 of the Indian Stamps Act, 1899, states that all documents chargeable with duty and executed by any person in India shall be properly and duly stamped before or at the time of execution. A document, whereon the stamp affixed is for an amount in excess of that which may be legally required, is considered as duly stamped. An unstamped or insufficiently stamped documents will not be admitted in evidence or form the basis of a suit. Permission, however, can be accorded in certain cases by the court or an appropriate authority to admit an unstamped or insufficiently stamped document in evidence, on payment of certain penalties in addition to the duty with which the same is chargeable or in the case of an instrument insufficiently stamped of the amount required to

make up such duty. It must, however, be remembered that an unstamped or insufficiently stamped acknowledgement of debt, promissory note, or a bill of exchange is an invalid document ab initio and cannot be admitted in evidence even on payment of duty and penalty. A suit based on such an acknowledgement, promissory note or bill of exchange would, therefore, fail in law.

A document must be stamped according to the stamp duty as leviable in the State where the document is first executed by one or some of the parties. If such a document is to be executed by one or some of the parties in another State additional stamp duty in excess of stamp duty already paid as may be leviable in such other State, should be paid and the document stamped accordingly. If the stamp duty leviable in such other State is equal to or less than the stamp duty paid, then no action is called for. If, however, such additional stamp duty is to be paid, it should be paid by sending the document to the Stamp Office within three months of the receipt of the document in such other State.

Types of stamps: There are three kinds of stamps: impresed adhesive and non-judicidal.

1. Impressed stamps include: (a) lables affixed and impressed by the proper officer, and (b) stamps embossed or engraved on stamped paper. These stamps are impressed or engraved by Collectorate of the State concerned or an appropriate authority on banks printed standard forms like letters of lien, set-off, guarantee and hypothecation. Banks send 'printed forms to the collectorate with the requisite amount of stamp duty. The forms are impressed or engraved with stamps according to the stamp duty prevailing at the time. Every instrument written upon paper stamped with an impressed stamp has to be written in such a manner that the stamp may appear on the face of the instrument and cannot be used for or applied to any other instrument.

2.Adhesive stamps are those stamps which are affixed on the documents by gum Certain documents like demand promissory notes, receipts, acknowledgements of debt are stamped with adhesive revenue stamps. Postage stamps cannot be used on such documents. Adhesive stamps, when used, must be duly cancelled by the borrower by signing across them or otherwise, the idea being that the same stamp cannot be used again. Simply, drawing of a line across a revenue stamp cannot be considered as cancellation of the stamp, since anyone could sign on the top of the line again and re-use the stamp. The pro note on which the revenue stamp only bears a line across it is therefore inadmissible in evidence. If the stamp is not cancelled, the document will not be admissible in evidence unless the stamp duty and the penalty, if any, under the Indian Stamp Act, 1899 are paid.

Non-judicidal stamp are printed on paper by the Government. Such papers are available in different denominations. These papers are used for execution of agreements like indemnity bonds, sale deeds, mortgage deeds. The

denomination of the paper (with requisite stamp duty), depends on the nature of the document and sometimes also on the amount of the right or property that it will affect.

The schedule of stamp duty on documents varies in' different states. The exact stamp that is required for any document should be ascertained before its execution.

Witnessing: Some documents require to be compulsorily witnessed, others do not. A mortgage deed, a gift deed and a sale deed of immovable property or a 'will' require to be attested by at least two witnesses. Attestation must follow execution, not precede it. A promissory note, a letter of guarantee or a letter of pledge/hypothecation is not required to be witnessed.

The promissory note, may not be attested by a witness. Such a course, if followed, will avoid any controversy on the point.

In this context, it may be of interest to note some of the traits that Jistinguish a pronote from a bond. In a pronote, there is an unconditional undertaking to pay; it may not be so in a bond. In a pro note, the sum payable is certain, not necessarily so in a bond. A pronote is a negotiable instrument, i.e. the payee can negotiate the instrument by endorsement, it being payable to the payee or his order. The bond lacks this basic characteristic; it is not a negotiable instrument.

Both the pronote and the bond require to be signed by the maker thereof. A pronote does not require to be attested by a witness, a bond does require attention. Stamps of nominal value are affixed on a pronote. A bond is stamped ad valorem, thus attracting much higher stamp duty than a pronote.

Other legal formalities: Some documents, e.g. a mortgage deed have to be registered at the office of the Sub-Registrar of Assurances under the Indian Registration Act, 1908. If the borrower is a limited company, certain charges have to be registered with the Registrar of Companies under Section 125 of the Companies Act, 1956. The mortgage or charge must be registered within the prescribed period.

In the case of borrowings by a company, the bank must have on record a certified copy of the resolution passed at a meeting of the Board of Directors and not by circulation. Some banks insist that the Common Seal of the company must be affixed on all documents execute~ on behalf of the company. This is not legally necessary unless specifically required in respect of any particular document in terms of the Articles of Association of the company or the relative resolution of the Board. The directors or the officers of the company, duly authorised by a Board resolution or under a power of attorney, may sign the documents.

Documents Executed Register: Banks usually maintain a 'Documents Executed Register', in which the date, the names of the executants, the amount/limit of the advance, the nature of the documents and the security are mentioned. The entries are signed in full by the bank officers in whose presence the documents are executed by the borrowers. This register is

admissible in evidence in a court of law. The ,entries in the register also enable the officers concerned to recollect and prove in the court, the execution of the documents by the parties, in case a dispute arises in this regard.

IMPORTANT PROVISIONS OF INDIAN STAMP ACT, 1899

The stamp duty should be according to Stamp Law prevalent in the particular 'state. The stamps may be adhesive, special adhesive, embossed or engraved.

Unstamped documents or under stamped documents fall in two categories: . In the first category are included, acknowledgment of debt, delivery order in respect of goods, marine insurance policy, policy in insurance by way of indemnity, demand promissory notes of value not exceeding Rs. 250, etc. These documents are not at all admissible in evidence and are for all practical purposes mullities.

Except these documents all others fall in the second category. They are admissible in evidence even if they are unstamped or inadequately stamped upon payment of a penalty which may be, at the maximum, ten times the duty chargeable.

When a document is required to be executed by two persons in different states in India, it must bear the stamp duty of that state where it is signed first. It is then sent to the second state for the signature of the other person. If in that state, the stamp duty is higher than that in the first state, the excess amount will have to be paid before the second person signs it. If the document is signed in one state and is to be acted upon in another state where the duty is higher than the duty in the former state, the deficit amount should be paid in the state where it is be acted upon within 3 months of its receipt in the latter state.

Stamp duty on a document can be adjudicated upon by the Stamp, Authority. Adjudication will be in the form of a certificate which should be affixed to the document within one month of its execution.

A document signed in a foreign country need not be stamped abroad.

Such document should however be stamped in India within 3 months of its receipt by presenting it to the stamp office of the state where it is to be acted upon.

Cancellation of stamp: Stamps must not only be affixed but cancelled so that they cannot be used again. The manner of cancellation is that the drawer writing his name or the initials of his firm and date across the stamps or any other effectual means, such as, perforation. Merely drawing two lines across the stamps will not suffice as such stamps can be used again.

Specified stamps: If a stamp other than that specified in the Stamp Rules is used, the instrument is deemed to be unstamped.

Non-judicial stamp paper: A non-judicial stamp paper should bear the marks of the stamp vendor. The date of the document must be the same or subsequent to the date of issue of the judicial stamp paper.

Continuation sheets: Where continuation sheets are required in addition

to a non-judicial stamp paper, these should be water marked papers of Government of India. Continued matter on ordinary sheets may be successfully challenged by the executants.

LIMITATION

The object of the law of limitation is to prescribe the period within which existing rights can be enforced in a court of law. The statute does not of itself create an obligation or a right to sue where none existed; it simply imposes a time limit to litigation. By placing a limit on the period within which a plaintiff can file a suit, an applicant make an application or an appellant prefer an appeal, the statue is considered to have brought repose, peace and justice to the contending parties. It brings repose because it extinguishes stale demands and quiets title. In the words of John Voet, controversies are restricted to a fixed period of time lest they should become immortal while men are mortal. It secures peace as it ensures security of rights; and it secures justice, as by lapse of time evidence in support of rights may have been destroyed.

According to Section 3 of the Limitation Act, 1963, every suit instituted, appeal preferred and application made after the prescribed period shall be dismissed, even if limitation has not been set up as a defence. However, under Section 5 of the said Act, an appeal or an application under any of the provisions of Order 21 of the Code of Civil Procedure, 1908, may be admitted after the prescribed period if the appellant or the applicant satisfies the court that he had sufficient cause for not preferring the appeal or making the application within such period. Bankers have, therefore, to watch carefully the period of limitation as laid down in the said Act.

Waiver of limitation

The parties cannot, by agreement, express or implied, extend or alter the period of limitation as laid down by law. It is also not possible for them to waive limitation by agreement. An agreement not to raise the, plea of limitation in case a suit/application/appeal is tiled/made/ preferred is inoperative and ineffective.

Extension of period of limitation - General

Limitation can be extended by the acts of the parties in any of the following three ways:

(a) **Fresh documents:** If the borrower executes a fresh promissory note or a new bond, etc., for the old debt, the limit is automatically extended from the date of the fresh document. The document may even be executed after the period of limitation has expired, as an old debt is a good consideration in the eyes of the law. I Bankers, however, do not depend on the sweet will of the borrowers in such cases, who mayor may not execute fresh documents. In case, therefore, new documents have to be taken, that should be done much before the limitation expires.

(b) **Acknowledgement:** The limitation for filing a suit or an application in respect of any property or right can also be extended by an acknowledgement.

The acknowledgement has to be in writing, signed by the party against whom the liability is sought to be enforced or by his duly authorised agent across the requisite revenue stamp, before the expiry of the prescribed period of limitation. It should preferably be dated, as the leading of oral evidence to prove the date of its execution, though permissible in law, would be rather difficult.

In the case of a joint or a partnership account which is in debit, all persons who are liable, jointly or as partners, must sign the acknowledgement. One of several joint debtors cannot keep the debt alive and subsisting against the other joint debtors, by reason only of a written acknowledgement signed or payment made by himself. The creditor, in order to claim extension of the period of limitation, will have to prove that the debtor, who signed the acknowledgement or paid the money, is a duly authorised agent of the other debtors

If it is a guaranteed account, the acknowledgement must also be signed by the guarantor. Banks insist on borrower's acknowledgement by means of 'confirmation letters' half-yearly or annually, not only for getting the debit balances in the accounts confirmed but also with a view to obtaining a fresh lease of limitation.

A suit against the surety (guarantor) must be instituted within three years from the date of execution of the guarantee. An acknowledgement of liability by the principal debt or alone does not automatically extend limitation against the surety. The surety must be a party to the said acknowledgement to make him liable.

(c) Part-payment: Part-payment of a debt or interest can also extend the period of limitation, provided such payment has been authenticated by the borrower or his duly authorised agent under his signature. The partpayment should also have been made before the expiry of the prescribed period of limitation. A remittance sent by the party under his signature for the credit of his account will also have the same effect. If a borrower Jeposits some money in his advance account by a pay-in-slip signed by him, before the debt becomes time-barred, the effect will be to extend the period of limitation with effect from the date of the part-payment.

In both the cases - signing the acknowledgement and making the part-payment - a fresh period of limitation is computed from the date when the acknowledgement was signed or the part-payment made. It should, however, be emphasised, that the acknowledgement or the part payment after the expiry of limitation, will not extend the period of limitation

Exclusion of period of limitation in special cases

The Limitation Act, 1963, provides that limitation shall be excluded in certain cases. A few important exceptions are given below:

(a) Legal disability: Where a person entitled to institute a suit or make an application for execution of a decree is, at the time from which the ?rescribed period is to be reckoned, a minor or insane or an idiot, he may institute the suit

or make the application within the same period after the disability has ceased, as would otherwise have been allowed from the time specified therefore in the Limitation Act, 1963 (Section 6).

(b) Court is closed: Where the prescribed period for any suit, appeal or application expires on a day when the court is closed, the suit appeal or application may be instituted, preferred or made on the day when the court re-opens (Section 4)

(c) Disability of one of several persons: Where one of several persons jointly entitled to institute a suit or make an application for the execution of a decree is under any legal disability and a valid discharge cannot be given, time will not run as against any of the said persons until one of them becomes capable of giving valid discharge without the concurrence of the others or until the disability has ceased (Section 7).

(d) Fraud or mistake: Where, in the case of any suit or application for which a period of limitation is prescribed by the Limitation Act, 1963:

(i) The suit or application is based upon the fraud of the defendant or respondent or his agent; or

(ii) The knowledge of the right or title on which a suit or application is founded is concealed by the fraud of any such person as aforesaid; or

(iii) The suit or application is for relief from the consequences of a mistake;

or

(iv) Where any document necessary to establish the right of the plaintiff or applicant has been fraudulently concealed from him;

The period of limitation shall not begin to run until the plaintiff or applicant has discovered the fraud or the mistake, or could, with reasonable diligence, have discovered it, or in the case of a concealed document, until the plaintiff or the applicant first had the means of producing the concealed document or compelling its production

(e) Defendant is abroad: In computing the period of limitation for any suit, the time during which the defendant has been absent from India and from the territories outside India under the administration of the Central Government, shall be excluded (Section 15(5)).

(f) Day to be excluded: In computing the period of limitation for any suit, appeal or application, the day from which such period is to be reckoned, shall be excluded (Section 12(1)).

Period of limitation: The period of limitation for filing a suit for the recovery of money lent under a demand promissory note is three years from the date of the execution of the document. The D.P. note mayor may not be accompanied by security, by way of pledge or hypothecation. The period of limitation is three years in either case. If a temporary overdraft is created in the account of a customer and he does not adjust it, the suit has to be filed within three years from the date of the overdraft.

If the amount is recoverable on the basis of a bill of exchange or a promissory note payable at a fixed time after date, the period of limitation is three years from the date when the said bill or promissory note falls due. In the case of an advance on a bond where no date is specified for payment, a suit has to be filed within three years from the date of the execution of the bond.

If an advance has been made on a mortgage of immovable property or is otherwise secured by a charge upon immovable property and the money is payable by the mortgagor on demand and no instalments are agreed to, the banker must file a suit within twelve years of the date of the mortgage deed. If the mortgage money is payable by instalments and the mortgage deed provides that if default is made in payment of one or more instalments, the whole amount shall fall due. The period of limitation is twelve years from the date when the default is made unless where the payee or obligee waives the benefit of the provision and then when fresh dafualt is made in respect of which there is no such waiver.

If the mortgagee (banker), however, wants a personal decree against the mortgagor, the banker will have to file a suit within three years of the execution of the mortgage deed or the date of the default, as the case may be

Limitation-application and appeals: The period of limitation for making various types of applications to courts varies from 10 days to 90 days except in a few specified cases, e.g. application for the execution of a money decree can be filed within twelve years from the date when the decree becomes enforceable.

An appeal against an order or decree of a lower court which has to be heard by a High Court must be preferred within 90 days of the order or decree. If any appeal has to be made to any other appellate authority lower than the High Court, the corresponding period of limitation is only 30 days. It is always advisable to consult the bank's counsel on such matters

IMPORTANT PROVISIONS OF INDIAN LIMITATION ACT, 1963

The Limitation Act stipulates periods within which suits may be filed based on different documents. Limitation operating on some important documents is as under

Description	Limitation Period	Period to run from
(a) D.P. Notes	3 years	Date of execution
(b) Agreements	3 years	Date of execution
(c) Tenn loans	3 years	Date on which instalment is due for payment
(d) Revivalletters	3 years	Date of execution
(e) Balance Confirmations	3 years	Date of execution
(f) Acknowledgement	3 years	Date of execution
(g) Decree/awrded by court of law	12 years	Date when decreebecomes enforceable
h) Suits relating to immovable property: to enforce payment of money secured by mortgage or otherwise charged upon immovable property	12years	When money becomes due
(i) Suits by a mortgagee		
(i) For foreclosure	30 years	When the money by the mortgage becomes due
(ii) For possession of immovable property mortgaged	12 years	When the mortgagee becomes entitled to take possession.
(iii) For enforcement of personal liability of mortgagor	3 years	From the date of deed (or from date of default)
(j) Suits by a Government of India body. Any suit (except a suit before the Supreme Court in the exercise of its original jurisdiction) by or on behalf of the Central Government or any state Government	30 years	The period of limitation begins to run under Limitation Act against alike suit by a private concern

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