

**BANKING AND DEBT RECOVERY:  
A COMPARATIVE STUDY OF THE LAW AND PRACTICE IN  
INDIA, SRI LANKA AND MALAYSIA**

BY

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THESIS SUBMITTED FOR THE DEGREE OF  
DOCTOR OF PHILOSOPHY

LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE  
UNIVERSITY OF LONDON

1998



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## **ABSTRACT OF THESIS**

Current economic development law theories and technical assistance practices of international financial institutions emphasise the critical importance for an emerging or transitioning economy in moving towards a market orientated system, to have in place a modern commercial law infrastructure so that the economy can develop robust credit and other financial markets and can attract internal and external capital investments. One essential element of this desired commercial law infrastructure is a legal and judicial framework that provides for an efficient and prompt debt recovery process. Unfortunately, recent studies indicate that, in most developing countries debt recovery is in crisis.

The subject matter of this volume will be debt recovery in South Asia countries of India, Sri Lanka and Malaysia. These countries have been chosen for different reasons: India because it represents one of the largest emerging economies; Sri Lanka because its relevant legal system is a mix of English Common Law and Roman Dutch Law concepts; and Malaysia because it has achieved significant economic and financial modernisation through a rather special governmental-societal approach. Hopefully such a comparative analysis will shed some light on how to improve debt recovery laws in emerging economies in a manner conducive to sustainable economic and social development.

The ultimate thesis of this manuscript is that a suitable debt recovery system for an emerging economy requires, not simply suitable laws and judicial remedies, but also appropriate financial industry practices as to credit allocation and loan supervision; a broad range of fair and effective enforcement mechanisms; and an independent, commercial trained and responsive judiciary.

The conclusion looks at the present state of the development of the banking sector in the selected three countries, with special attention being given to the apparent tensions between the market orientated policies that are being ambitiously pursued and the laws that govern credit, security and debt recovery.

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## PREFACE

On 12 February 1996 the London School of Economics conducted a seminar for its new research students on “How to do your PhD.” We were told:

*“...you are required to write a thesis on a chosen topic to a maximum of 100,000 words, not a Royal Charter!”*

Described in this manner, the task ahead appeared to be less daunting. Nevertheless, it was not an easy one, and I could not have accomplished it without the assistance and support of many. I am however, solely responsible for what is written in this thesis.

I have been very fortunate to have my research supervised by Professor Ross Cranston, Cassel Professor of Commercial Law at the London School of Economics, (as he then was) one of the foremost authorities in Banking Law in the United Kingdom. I am indebted to him for his guidance and support throughout my research. He has always been available to discuss problems of an academic nature and been understanding and sympathetic where it has been more personal. I am particularly grateful to him for continuing to supervise me after entering Parliament as a member in 1997 and even after assuming Public Office this year.

The London School of Economics awarded me a studentship of £5000/= every academic year, which was used to pay my college fees and expenses incurred during my studies. I am grateful to the scholarships committee for awarding me this studentship as it gave me the opportunity to become a research student at LSE.

In May 1997, I travelled to Malaysia to continue my research in that jurisdiction. The Central Research Fund of the University of London granted me £495/= towards the cost of my airfare and the Law department of the London School of Economics gave me £200/= for my expenses. I thank both these institutions for their kind contributions. While I was in Malaysia I was introduced to many academics, lawyers, bankers and insolvency practitioners all of whom willingly gave me the assistance I sought. It is not possible to thank all of them individually but I appreciate the interest they have shown in my work and thank them for the documents they have provided.

In February 1996 and April 1997, I spent time in Sri Lanka to carry out research for my thesis. During my research I interviewed several people that were connected to my subject and thank them for their assistance. Mr Palitha Gunasekera, Chief Legal Officer of the Peoples’ Bank of Sri Lanka in particular was very helpful.

I must also thank Mr M.D. De Silva, Legal Director of Lewis Brown & Co., Ltd., Mr L Abeysekera, Retired High Court Judge, Mrs S. Gunaratne of the Central Bank, Mr A.

Athurupana, Attorney at Law, Mr Nithi Murugesu of Messrs Murugesu and Neelakandan, all in Sri Lanka and Miss S. Jamnekar in India for finding information and sending it to me from abroad, often at short notice.

Mr Murad Uduman helped me to proof read the thesis and also made useful comments on the text. I greatly value the assistance he gave me and thank him for it.

Elizabeth Durrant, Post Graduate Secretary at the Law Department willingly assisted me in all my dealings with the college. The library staff at the London School of Economic frequently helped me with my queries. Everyone at the Institute of Advanced Legal Studies has been very helpful to me throughout my research and I could not single any one out by name. Each of them, particularly those with whom I had the pleasure to work for almost two years, always took a lot of trouble to assist me with complicated research queries, which arose quite frequently. I appreciate the support and encouragement they gave me. I wish the Institute continued success.

My husband's family has shown a continued interest in my work and willingly sent me information from Sri Lanka as and when I needed it. I appreciate their kindness.

Less than a year into my Ph.D. research, my son Charith was born. As every parent knows my life changed dramatically. My mother came from Sri Lanka and spent over eighteen months with us and helped me to look after Charith. She was a constant source of encouragement and willed me to carry on with my work particularly during difficult times. My sister and brother enabled my mother to travel by taking care of her affairs in Sri Lanka whilst she was away, and continued to encourage me from across the seas.

My husband, Niranjana, and I have had many discussions and disagreements about my thesis and I am indebted to him for his guidance and inspiration at every stage. Niranjana also sacrificed and endured much so that this thesis may be completed. This thesis is dedicated to the three most important people in my life, my mother Priyani, Niranjana, and last but by no means least, my young son Charith.

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Sonali Abeyratne

19 November 1998

“If as RABEL hinted there are any natives with arrows lying in wait for comparatists who venture into the thickets of their law the password is: every student serves the truth.”

Zweigert, K., and Kotz, H. *Introduction to Comparative Law*, 2nd Ed.,  
(Translated by Tony Wier) Clarendon Press, Oxford, 1987, vi

# CHAPTER ONE

## INTRODUCTION

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- 1.1 *THE NEW MARKET ECONOMIES*
  - 1.1.1 *Foundations for a Sound Market Economy*
  - 1.2 *MARKET REFORMS AND GOOD GOVERNANCE*
  - 1.3 *THE ABSENCE OF A MARKET FRIENDLY LEGAL ENVIRONMENT*
  - 1.3.1 *Characteristics of a Market Friendly Legal Environment*
  - 1.4 *DEBT RECOVERY: THE PROBLEMS*
  - 1.4.1 *Debt Recovery in India, Sri Lanka and Malaysia*
  - 1.5 *SCOPE OF THIS THESIS*
- 

### 1.1 *THE NEW MARKET ECONOMIES*

During the first part of the twentieth century, countries containing one third of the world's population moved from being largely market economies to centrally planned economies. In the early years, the economic and social achievements of the centrally planned economies were considerable,<sup>1</sup> but over a period of time central planning became inefficient, consumer demands were not satisfied, social indicators began to worsen, and economic crisis appeared to be inevitable.<sup>2</sup> The socialist countries in the

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<sup>1</sup> From Plan to Market : *World Development Report*, Oxford University Press, New York, 1996, 1

<sup>2</sup> President Gorbachev, explained the short comings of the former Soviet Union's economic system as follows :

“It is above all the lack of inner stimuli for self-development. Indeed, through the system of plan indices, the enterprise receives assignments and resources. Practically all expenses are covered, sales of products are essentially guaranteed and, most importantly, the employees' incomes do not depend on the end results of the collective's work: the fulfilment of contract commitments, production quality and profits. Such an economy is likely to produce medium or even poor quality of work, whether we like it or not. How can the economy advance if it creates preferential conditions for backward enterprises and penalises the foremost ones?”

Gorbachev, M., *Perestroika : New Thinking for Our Country and the World*, Collins,

then Soviet Bloc realised that their experiment with central planning had to be abandoned, and that it was necessary once again to adopt liberal economic policies, open their economies to the world at large, and encourage local and foreign investors.

Yergin and Stanislaw observe:

“Nowhere else has the recasting of the relationship between state and market been so extreme as in the former communist world, for the upheaval has set off a turbulent struggle to establish market systems in the very countries where markets had for so long been banished. The communist system claimed to be the vanguard of the future, but it buckled under the pressure of its inner decay. The machinery of central planning and state ownership failed to foster innovation and distribute the benefits of economic growth - and then it failed to deliver any growth at all.”<sup>3</sup>

Countries, which did not wish to fully embrace the centrally controlled model for economic development, settled for a hybrid economic policy, which borrowed practices from both types of economy. The extent to which countries have adopted policies from planned or market economies varied according to the social and economic policies followed by each country. The best known is the approach taken by Japan and South Korea.<sup>4</sup> They are both market systems that promote export trade but maintain strong co-operation between the government and corporate sector. The governments provide “administrative guidance” to businesses so that they may adapt to the world export markets.<sup>5</sup> Whatever economic policies were followed in the past, the current trend in most developing economies is a shift towards a decentralised, free market system

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London, 1987, 85

<sup>3</sup> Yergin, D., and Stanislaw, J., *The Commanding Heights*, Simon and Schuster, New York, 1997, 263

<sup>4</sup> Gutterman, A., & Brown, R., (Eds) *Commercial Laws of East Asia*, Sweet and Maxwell, Hong Kong, 1997, 13-14

<sup>5</sup> However, the Japanese recession that began in the early 1990's has opened the debate whether the relationship between the market place and the state must be changed to facilitate more deregulation of the economy. The debate is still continuing. See *East Asian Miracle : Economic Growth and Public Policy*, World Bank, Oxford University Press, 1993, 101-102; Yergin, D., and Stanislaw, J., *The Commanding Heights*, Simon

underpinned with widespread private ownership.

### 1.1.1 *Foundations for a Sound Market Economy*

A country that fosters a free market economy must promote a stable economic and political environment that is conducive for economic development, a sound legal and judicial framework where independent and expeditious dispute resolution is possible, and put in place certain regulatory and institutional arrangements that may be necessary to have a sound financial system.<sup>6</sup>

In order to create a stable economic environment in a free market system, it is essential that the economy is open to domestic and international competition and any barriers of entry are removed. The state needs to adopt free trade policies and local industries are expected to compete in international markets. The national government should not discriminate between production for the domestic market and exports, or between purchase of domestic and foreign goods. Government subsidies are not made available to enterprises and they have to bear the risks of market transactions, ensure financial discipline and generate profits. Market forces are allowed to determine the interest rates and foreign exchange rates, and the state is expected to exert minimum influence over such matters.

If a free market economy is to thrive, such a country requires laws that are fair, clear and known to its people. Law enforcement agencies should maintain law and order by applying the law when conflicts arise and be impartial. It is vital that the legal system is independent and is able to resolve disputes within a reasonable time and cost. The World Bank has recognised that:

“In many countries the inappropriateness of laws, uncertainty in their application, weak enforcement, arbitrariness of discretionary power, inefficient court administration, slow procedures, and the subservience of judges towards the executive branch greatly hinder development, discourage and distort trade

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Schuster, New York, 1997, 164

<sup>6</sup> Norton, J., *Financial Sector Reform and International Financial Crises : The Legal Challenges*, Paper Presented at the WG Hart Workshop on Transnational (Corporate) Finance and the Challenge to the Law, (Unpublished), 1998

and investment, raise transaction costs, and foster corruption. Laws may be unenforceable because they contradict economic logic, thereby destroying the incentive for compliance.”<sup>7</sup>

In addition to a stable economic environment and a sound legal and judicial system, emerging market economies require certain regulatory and institutional arrangements that will assist in building a liberalised financial system.<sup>8</sup> It is important that a market economy avoids pursuing “repressive” financial policies, such as controls on deposit and lending rates of interest that result in negative real rates, and allocation of credit to specific sectors that distort the credit market. However, the importance of following prudential monetary policies that regulate the markets cannot be undermined. Further, the fundamental principle upon which financial institutions operate is that ‘money that goes out must come back.’ In other words deposit funds may be used to give loans but those loans must be recovered. If the process of granting loans is not carried out in a professional manner and is influenced by political interference, malpractice and corruption the obvious result is that banks will fail to recover their loans. In addition, if banks neglect to monitor the loans after they have been granted, or the accounting rules disguise the poor quality of bank portfolios it will create a climate of self-deception and operational inefficiency. Such an environment will invariably threaten the viability of the banks and impose a burden on a country’s economy.

## 1.2 MARKET REFORMS AND GOOD GOVERNANCE

The primary responsibility of a government in a transitioning or developing market economy, is to bring about the required changes to the economic, legal and financial environment in an orderly and structured manner. Good government is therefore important to achieve these economic goals.

There is no universal model for good government against which performance can be judged, but it may be said that good government requires competence and accountability in the public sector, transparency of government activities including easy access to information, and a proper legal framework that ensures that the rule of law

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<sup>7</sup> *Governance : The World Bank’s Experience*, World Bank, Washington DC, 1994, 23

<sup>8</sup> Roe, A., *Financial Sector Reform in Transitional Socialist Economies*, EDI Policy Seminar Report No. 29, World Bank, Washington D.C., 1992, Chapter 4

prevails. Competence in government and an efficient legal system, for example, are of little value if governments pursue policies that are repressive or dictatorial, and infringe on human rights. Conversely, a government, which is well meaning in terms of participation and consent, is of little value if it is incompetent

The concept of “good government” or “good governance” as it is often described eludes precise definition, as there are differences in opinion as to what constitutes “good governance.”<sup>9</sup> There are, however, a number of common features which are identifiable in the lending policy guidelines of various governments and institutions engaged in the provision of financial assistance.

Most developing and transitioning economies that are moving towards a market orientated system are dependent on foreign financial assistance to a greater or lesser extent. Since the early nineties, international financial institutions, foreign governments and aid donors have become increasingly aware that economic development cannot proceed without some degree of open pluralistic forms of government. This has prompted aid donors to attach ‘political conditions’ to the granting of aid.<sup>10</sup> In June 1990, in a much-publicised speech, the British Foreign Minister, Douglas Hurd said:

“Governments tending towards pluralism, respect for the rule of law, human rights and market principles should be supported. But assistance should be withheld from Governments rejecting these criteria, or making no effort to move towards them.”<sup>11</sup>

A year later the Minister for Overseas Development, Lynda Chalker (now Baroness Chalker) outlined the elements of good government in more detail,

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<sup>9</sup> Crawford, G., *Promoting Democracy, Human Rights and Good Governance Through Development Aid : A Comparative Study of the Policies of Four Northern Donors*, University of Leeds Press, Leeds, 1996, 70; For a criticism of the concept, see Leftwich, A., *Governance, the State and the Politics of Development*, (1994) 25 *Development and Change* 363, 364; Leftwich, A., *Governance, Democracy and Development in the Third World*, (1993) 14 *Third World Quarterly* 605, 612

<sup>10</sup> Robinson, M., *Governance, Democracy and Conditionality : NGOs and the New Policy Agenda* in Clayton, A., (Ed) *Governance, Democracy and Conditionality: What Role for NGOs?*, Intrac Publications, Oxford, 35, 47-50; Mosley, P., et al, *Aid and Power : The World Bank and Policy Based Lending* Vol. 1, 2nd Ed, Routledge, London, 1995 65-67

<sup>11</sup> *The Prospects for Africa in the 1990's*, Transcript of Speech Given at the International Conference on African Prospects in the 1990's, at the Overseas Development Institute, London on 6 June 1990, 2; See also Aukomah, B., *The Quest for Better Government* [1990] *African Business*, 16



emphasising the introduction of market forces and the encouragement of private sector activity, the need for competent and accountable government, pluralism and democracy, and respect for human rights and the rule of law.<sup>12</sup> The Council (Development) of the European Union in its 1991 resolution on ‘Human Rights, Democracy and Development’ stressed the importance of good governance.<sup>13</sup> The resolution states, inter alia, that the creation of a market friendly environment for development as well as respect for the rule of law are central to the existing or developing interdependent relationships.<sup>14</sup> In the same year in the United States, the Agency for International Development (USAID) published a policy paper entitled “*Democracy and Governance*” which described its overall policy on aid as being based amongst others on strengthening democratic representation (expanding free markets is now discussed under “Democracy”) and promoting ‘lawful governance.’<sup>15</sup> USAID promotes ‘lawful governance’ by supporting the legal and judicial systems of a country and government accountability at state and local levels.

The World Bank, the major player in world development activities, has recognised that good governance is synonymous with sound development management.

“Good governance is central to creating and sustaining an environment which fosters strong and equitable development, and it is an essential complement to sound economic policies.... They establish the rules that make markets work

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12 *Good Government and the Aid Programme*, Transcript of Speech Given at the Royal Institute of International Affairs, Overseas Development administration, London, 1991, 2-3

13 This resolution is of great importance. It is the first time a joint resolution between the Council and Member States have been made as to a common policy by all the European Community Countries on aid granting.

14 The text of the Resolution is cited in *Democracy and Development* (1991) 11 Bulletin of the European Communities 122-123

15 Cited in Crawford, G., *Promoting Democracy, Human Rights and Good Governance Through Development Aid : A Comparative Study of the Policies of Four Northern Donors*, University of Leeds Press, Leeds, 1996, 21

efficiently and, more problematically, they correct for market failures.<sup>16</sup>

What does the World Bank mean by “good” and “bad” governance? The main characteristics of “bad” governance is identified as,

- Failure to make a clear separation between what is public and what is private, hence, a tendency to divert public resources for private gain
- Failure to establish a predictable framework of law and government behaviour conducive to development, or arbitrariness in the application of rules and laws
- Excessive rules, regulations, licensing requirements, and so forth, which impede the functioning of markets and rent seeking
- Priorities inconsistent with development, resulting in a misapplication of resources
- Excessively narrowly based or non transparent decision making<sup>17</sup>

Good governance must then be the opposite. It may be epitomised as essentially being non political, “predictable, open and enlightened policy making; a bureaucracy imbued with professional ethos; an executive arm of government accountable for its actions; and a strong civil society participating in public affairs.”<sup>18</sup> It is also a system of institutional checks and balances where rules and institutions “provide a predictable and transparent framework for the conduct of public and private business.”<sup>19</sup>

The concept of good government or good governance evolved from such policy guidelines for financial assistance. Whilst it is clearly difficult to define what good governance is, there are, however, at least two common features that can be identified in these policy guidelines, namely, adherence to market principles and respect for the rule of law.

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<sup>16</sup> *Governance and Development*, World Bank, Washington DC., 1992, 1

<sup>17</sup> Ibid. 9

<sup>18</sup> *Governance : The World Bank's Experience*, World Bank, Washington DC., 1994, vii

When a country has a legal system that has sound laws that reflect the economic policies it is pursuing, judicial and administrative institutions that implement the legislation expeditiously, and a legal system that is sufficiently insulated from the locus of political influence, it may be said that the rule of law prevails in that country.

A developing a market economy may not have all these criteria and may need to be reformed. However, the content and scope of improvements that needs to be done will largely depend on each country.<sup>20</sup> For example, such a country may need reform in specialised areas of law, such as debt recovery, security, capital markets, and bankruptcy laws. In some countries a clear framework of effective laws that are enforceable may have to be developed through support for their drafting, and the repeal of laws and regulations that do not conform to current economic policies.<sup>21</sup> Strengthening the capacity of the courts system in both judicial and administrative processes may be required to ensure fairness, and to avoid unnecessary delays, by assisting the modernisation of the courts and improving their administration, as well as the skills of various personnel attached to the legal system, such as court and fiscal officers. Enforcement of judgement debts is especially important. This may include addressing organisational and policy issues appropriate training such as teaching new skills, and the provision of equipment.

The World Bank considers it has an important role to play in establishing good governance in borrower countries. In particular, the World Bank has undertaken to

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<sup>19</sup> *Governance and Development*, World Bank, Washington DC., 1992, 3

<sup>20</sup> *The World Bank and Legal Technical Assistance : Initial Lessons*, Policy Research Working Paper No. 1414, World Bank, Washington DC., 1995

<sup>21</sup> Waelde, T., and Gunderson, J., *Legislative Reforms in Transition Economies : Western Transplants - A Short Cut to Social Market Economy Status?* (1994) 43 *International Comparative Law Quarterly*, 347

provide legal technical assistance to borrower countries with the objective of creating an optimal legal environment for the conduct of commercial and financial transactions.<sup>22</sup> In practice, the focus of law reform programmes have been on areas that have a direct link to economic development, particularly in the context of making markets work more effectively.<sup>23</sup> Notably, the Bank has assisted law reform programmes that facilitated privatisation, introduced or improved appropriate commercial and financial laws, and assisted in financial and judicial reforms.<sup>24</sup> The reason for this is to develop a modern commercial law infrastructure so that the economy can develop robust credit and other financial markets which can attract internal and external capital investments.

### 1.3 *THE ABSENCE OF A MARKET FRIENDLY LEGAL ENVIRONMENT*

In most countries that are in the process of liberalising their economies, the focus so far has been on promoting new economic policies. Legal and judicial environments in which competitive business organisations exist and commercial transactions take place have not been given the same priority. It has been observed that, in the Soviet Union:

“The biggest failure-and biggest threat to reform-continues to be the legal process, particularly as it relates to property rights, which are still the fundament of a market system. The legal system functions poorly; courts

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22 Faundez, J., *Legal Technical Assistance*, in Faundez, J., *Good Government and Law : Legal and Institutional Development in Developing Countries*, Macmillan Press Ltd., London, 1997, 1, 8-10 ; *The World Bank and Legal Technical Assistance : Initial lessons*, Policy Research Working Paper No. 1414, World Bank, Washington DC, 1995

23 McAuslan, P., *Law, Governance and Development of the Market : Practical Problems and Solutions*, in Faundez, J., *Good Government and Law : Legal and Institutional Development in Developing Countries*, Macmillan Press Ltd., London, 1997, 25, 27

24 For example, in China, the Bank sponsored an economic law reform project, in Kyrgyz Republic the Bank established Central legal reform units, in Moldova it assisted to prepare and co-ordinate law reform programmes, and in Venezuela the Bank financed judicial reform programmes. See Shihata, I., *The World Bank in a Changing World*, Vol. II, Martinus Nijhoff Publishers, Hague, 1995, 59, 138-139

are under financed and beholden to local political forces.”<sup>25</sup>

Sound laws, and independent judicial institutions which can implement those laws effectively, are therefore vital in any economy. Enacting appropriate laws is difficult, particularly if policy issues underlying the laws are not resolved, political pressures are intense, and experience in market reforms is limited. Nevertheless, an attempt should be made to enact laws that are market friendly because failure to do so imposes costs that go beyond the deficiencies in individual laws, to the integrity of the legal system itself. Laws passed with inconsistencies, omissions, or which contain ways of circumventing them will be mistrusted and not respected by people.

### 1.3.1 *Characteristics of a Market Friendly Legal Environment*

In order to create a climate of confidence conducive to private sector business activities appropriate laws that provide the necessary environment is necessary.<sup>26</sup> In this part the focus is on fundamental areas of the law which are vital in a legal environment that is market friendly. First, the laws should guarantee private property rights, which are the cornerstone of a market economy.<sup>27</sup> It is important that property rights are recognised and protected and the transfer of such rights is free from legal constraints. Title registration must be available and easy to accomplish, as well as the creation of security rights underpinning credit. It is essential that such rights be enforced expeditiously.

Second, it is important that parties to a transaction are allowed the freedom to

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25 Yergin, D., and Stanislaw, J., *The Commanding Heights*, Simon and Schuster, New York, 1997, 292

26 *Legal Aspects of Privatisation in Industry*, Economic Commission for Europe, United Nations, New York, 1992, 15-30

27 *From Plan to Market : World Development Report*, Oxford University Press, New

negotiate the terms of the contract.<sup>28</sup> For example, parties may wish to negotiate the essential elements of a contract such as the amount of a loan, the credit charges and terms of repayment, and be free to prescribe rules for dispute resolution, penalties, and guarantees which are designed to ensure the performance of contracts.

Third, well-defined and enforceable company and bankruptcy laws are essential to attract local as well as foreign investors.<sup>29</sup> Company law must define the legal entities which can transact different business activities, and grant them full legal personality. The legal rules that govern the incorporation, management, and operation of companies should be clearly stipulated. They must also set out minimum capital requirements, determine the extent of shareholders' liability for company debts, provide rules with regard to the sale and transfer of shares, and provide guidelines for corporate governance.

In addition, a well-designed insolvency law is necessary for the orderly exit of failing enterprises, thus freeing resources for more productive purposes.<sup>30</sup> Insolvency laws are also necessary provide for the reorganisation of enterprises that are in financial difficulties but have the potential to be revived. Such laws need to clearly set out the criteria for determining insolvency and efficiency enhancing priority rules for example, giving secured creditors preference over state claims, methods of reorganisation with workable voting rules and flexibility in the sale of assets in the event of a liquidation.

It has been argued that one of the most complex functions of market friendly

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York, 1996, Chapter 3

28 Gutterman, A., and Brown, R., *Commercial Laws of East Asia*, Sweet and Maxwell, Hong Kong, 1997, 28-30

29 Ibid. 34-36

30 Balz, M., & Schiffman, H., *Insolvency Law Reform for Economies in Transition : A Comparative Law Perspective* (1996) 11 Butterworths Journal of International

laws is to protect competition, and to create a level playing field in the market place.<sup>31</sup> Competition law needs to be designed to promote fair and effective competition among autonomous enterprises and to ensure that the interests of consumers are protected without the need for direct state involvement. The laws must ensure that enterprise mergers do not create barriers to new enterprises, for example credit providers which wish to enter the market and protect the consumers from monopoly power and cartel-like behaviour of enterprises. In addition to these fundamental areas of law, there are numerous other laws that are important for the proper functioning of a market economy.<sup>32</sup>

Appropriate legislation alone will not create an environment conducive to business activities. Laws are only as good as the institutions that enforce them. It is vital therefore that courts are responsible for enforcing laws and resolving disputes expeditiously.<sup>33</sup> Judges should take an active part in interpreting the law when obvious deficiencies in legislation are seen. It is also vital that disputes can be resolved with minimum delay and at a reasonable cost and enforcing judgements are smooth and effective. The laws may assist in attracting foreign capital by treating both foreigners and locals equally. Further, damages awarded by judges that adequately compensate for the losses incurred by aggrieved parties. (E.g., Misrepresentation about loans or securities) can have a positive effect on foreign investment. In addition, it is important

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Banking and Financial Law, 19-26, 65-72

31 Whish, R., *Competition Law*, 3rd Ed., Butterworths, London, 1993, 12-14

32 Capital markets and securities legislation, intellectual property and technology transfer laws, labour, health and environmental laws, tax laws and commercial banking laws are some examples.

33 Perdomo, R., *Justice in Times of Globalisation : Challenges and Perspectives for Change in the Administration of Justice in Latin America*, in *Justice and Development in Latin America and the Caribbean*, The Inter-American Development Bank,

that institutions such as securities commissions and anti-monopoly offices contribute to the enforcement of the law by requiring strict compliance with regulations. Equally important are the functions of institutions such as accounting firms, credit rating agencies, and institutions which produce and distribute information, and monitor market participants.

If the business laws of a country are not market friendly and the law enforcement agencies were inefficient, business costs such as transaction costs to arrange, monitor and enforce contracts will be high.<sup>34</sup> Litigation costs will inevitably rise. Where inefficiency exists, uncertainty prevails, and in such an environment prudent decision making, which is vital to business activities will be difficult. De Soto observes,

“Basically, what property rights, contracts, and extra contractual liability do is reduce uncertainty for people who want to invest their labour or capital in the development of existing resources...In any country, uncertainty or legal instability reduces the volume of long-term investment and investment in plant and equipment. People save less and invest the little they do save in such socially unproductive goods as jewellery, gold, or luxury property... The less costly the transaction and the more secure the right to enjoy the fruits of investment, the greater the real value of an economic activity. A law that is efficient in dealing with these elements will encourage people to identify and seize existing opportunities and will systematically increase the value of economic activity.<sup>35</sup>

It is therefore important not only to increase equity in the society and raise productivity, but also to ensure that the legal system is efficient and legal costs are moderate. No more so is this than in the areas of credit allocation and debt recovery. Economic development is more likely to occur in such an environment.

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Washington DC, 1993, 131, 134-135

34 Coase, R., *The Firm, The Market, and the Law*, University of Chicago Press, Chicago, 1988, 114 - 119

35 De Soto, H., *The Other Path*, Harper and Row Publishers, New York, 1989, 181-183



#### 1.4 DEBT RECOVERY: THE PROBLEMS

An essential element of this desired commercial infrastructure is a legal and judicial framework that provides for an efficient and prompt debt recovery process. Poor debt recovery continues to be one of the key reasons for financial distress in many lenders across the globe. In most developing countries, a significant proportion of loans made by banks and other financial institutions are in default. As a result many such lending institutions may be technically insolvent.<sup>36</sup>

Capital and interest receivables are amongst a bank's primary assets. Of these, interest comprises a bank's principal source of revenue and therefore profit. Accordingly, from a bank's perspective it is essential that its borrowers keep their contractual commitments and pay interest and capital as scheduled. Defaults are inevitable, but when they occur a bank should take appropriate remedial action or, failing that, recover the outstanding interest and capital promptly. If the bank neglects to do so or the recovery process is unduly protracted, the impact on the bank may be severe. The bank may end up with a very large outstanding loan portfolio, which in turn would affect the bank's own capital ratios. In such circumstances the bank may find itself having to offer higher than average deposit rates to attract more capital. Inevitably these higher rates will be reflected in the bank's lending rate. Higher lending rates may in turn adversely affect the average quality of future lending, forcing the bank to lend to high-risk borrowers. If the bank is to lend to the more creditworthy borrowers it may be

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<sup>36</sup> A bank is insolvent if the value of its assets is less than the value of its liabilities. "Net worth" is the amount by which assets exceed liabilities. Many banks in developing countries are insolvent and unable to earn the large sums needed to regain solvency; the negative net worth of some of these banks is many times their capital. A bank is liquid as long as it can meet its day to day operating expenses and withdrawals. Thus it is possible for a bank to be insolvent yet continue with its banking operations. *World Development Report*, Oxford University Press, New York, 1989, 73

forced to cut margins to levels which are insufficient to generate profits.

Brownbridge observes:

“The bank may be trapped in a cycle of high deposit and high lending rates which lead to high loan default rates, which in turn raises deposit rates through its impact on the perceived soundness of the bank.”<sup>37</sup>

In such circumstances the “moral hazard”<sup>38</sup> faced by the bank’s managers or owners is also exacerbated. As a bank’s capital diminishes, the incentives, which its owners have to preserve solvency, are reduced because, with limited liability, they would have to bear only a proportion of the losses incurred to creditors. If the problem grows out of hand and regulators begin to question a bank’s capital adequacy ratios it may also affect that bank’s ability to lend further or even threaten its very existence.

The effect of non-performing loans goes beyond its impact on lending institutions. Severe financial distress of lenders has a widespread negative impact on economic growth and development. It is particularly costly to developing countries.<sup>39</sup> A recent World Bank study carried out in ninety developing countries has revealed that in many countries, losses sustained by governments due to bank insolvencies amounted to 10-20% of Gross Domestic Product (GDP) and occasionally exceeded 50% of (GDP).<sup>40</sup>

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37 Brownbridge, M., *The Causes of Financial Distress in Local Banks in Africa and Implications For Prudential Policy*, UNCTAD Discussion Paper No. 132, UNCTAD, Geneva, 1998, 8

38 The “moral hazard” in this context concerns the adverse incentives to a bank’s owners to act in ways which are contrary to the bank’s creditors (primarily its depositors) by pursuing high risk lending (e.g. lending at high interest rates to high risk borrowers) which, if unsuccessful, would jeopardise the solvency of the bank. Ibid, 7; Berger, A., et al *The Role of Capital in Financial Institutions* (1995) 19 *Journal of Banking and Finance* 393, 398

39 *World Development Report*, Oxford University Press, New York, 1989, 71-73

40 Caprio, G., and Klingebiel, D., *Bank Insolvencies : Cross-country Experience*, World Bank Policy Research Paper No. 1620, The World Bank, Washington DC., 1996, Table 2

#### 1.4.1 Debt Recovery in India, Sri Lanka and Malaysia

Recent statistics show that debt recovery in India and Sri Lanka is in crisis. The problem in Malaysia is not so grave but it is a cause for concern to lenders. In India, during 1996-97, the non-performing loans were 13.75 % of the total outstanding loan portfolio of the banking sector.<sup>41</sup> In Sri Lanka, during the years 1996 –1997, non-performing loans amounted to 15% of the outstanding loan assets.<sup>42</sup> In Malaysia, the figure was less alarming. In 1996, the ratio of non-performing loans to total loan assets was 3.9%.<sup>43</sup>

In India and Sri Lanka the low collection ratio is primarily due to the inordinate delays experienced by institutional lenders when recovering debts through the court process. Because detailed statistics are not kept, it is not possible to state accurately how many debt recovery suits are pending in the courts, and as a result the amount of credit that is locked up in litigation. The Law Commission of India observed,

“It is frightening to note that when a case is pending over 10 years in the Supreme Court and recalling the fact that even High Court takes sufficiently long time to dispose of the case since its commencement in the court of original jurisdiction, must be pending over two decades. If anyone in search of justice has to wait for full two decades, that itself is sufficient to confess the failure of the system.”<sup>44</sup>

In Sri Lanka, the average delay is 6 years. If, however, the matter is referred to the superior courts, the delay extends to 10 years or more.<sup>45</sup> In Malaysia, a debt recovery

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41 *Report on Trend and Progress of Banking in India, 1996-97*, Appendix - Tables 1.1 (A)-(C)

42 These figures are not published in the Central Bank’s Annual Report. The Statistics were obtained from the Bank Supervision Department, Central Bank of Sri Lanka.

43 Bank Negara Annual Report, 1996, 92

44 *The Supreme Court : A Fresh Look*, 125th Report of The Law Commission of India, Government of India, Delhi, 1988, 11

45 Jayawardena, N., *Philosophy of Debt Recovery Legislation*, Paper Presented at the Seminar on Debt Recovery Legislation, on 2 September 1989 at Colombo, Sri Lanka

suit by way of summary procedure can be completed in 3-6 months.<sup>46</sup> A full trial may extend from 1- 1 1/2 years to a maximum of 3 years. Compared with India and Sri Lanka, the Malaysian court procedure is quite effective. However, there is a general consensus among bankers and lawyers that the administration of the court system could be more effective, and that there is room for improvement.<sup>47</sup>

The consequences of inordinate delays in recovering debts can be severe. Borrowers may be encouraged to disregard their payment obligations, and take advantage of the weakness in the debt recovery process. Willing defaulters may obtain loans with the deliberate intention of avoiding payment, and may dispose of their assets beyond the reach of lenders because of the tedious pace of debt recovery suits. In short, delays breed a credit culture of deliberate non-payment by defaulters.

At the other end of the scale, the problems of recovery may be avoided if due care is taken at the stage of credit allocation and in monitoring repayments. It is a truism that prudent lending minimises debt defaults. There may, however, be circumstances where, whether to lend or not is a matter which is beyond the exclusive control of the lender. External political pressures can undermine the quality of credit allocation, and the ability of banks to supervise and collect loan instalments aggressively. Kabraji describes the nature of this problem in Pakistan as follows:

“A fundamental political problem is that since the nationalisation of the banks in 1974 and the ensuing growth of public sector financial institutions, the provision of industrial and agricultural credit at the behest of the government of the day to its political supporters inside and outside the legislature has become a fertile source of political patronage. Likewise the invocation of the initiation and conduct of recovery proceedings is a

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46 Interview with Mr. M. Ismail, Senior Partner, Ismail & Co., Kuala Lumpur, on 30 May 1997, Interview with Mr. Ng Chih Kaye, Head, Credit Division, May Bank Head Quarters, Kuala Lumpur, on 30 May 1997.

47 Ibid.

significant factor in the overall picture... Recoveries against this class are therefore fraught with difficulties.”<sup>48</sup>

The Indian and Sri Lankan experience is no different. The Khusro Committee in India has been very critical of the political interference in credit allocation and debt recovery.<sup>49</sup> In Sri Lanka, it is said that as at 1997 the state banks had given Rs. 6-7 billion as political loans.<sup>50</sup>

In the absence of such political pressures, a lender must nevertheless be able to assess the creditworthiness of borrowers. The lack of sound credit information systems that are user friendly, accessible, and comprehensive would no doubt adversely influence proper credit appraisal by lenders. Further, bank staff may not be competent in administering modern loan transactions, and in solving the complex problems of borrowers. They may also lack training in the dynamics of the new credit culture. For example, the granting of credit to poor borrowers under group schemes which use peer pressure to recover debts.<sup>51</sup>

Bad management in lending institutions also affects debt recovery.<sup>52</sup> If internal controls are not in force, it will be difficult to hold individual officers responsible for either authorising or collecting loans. Bank officers would then lack the incentive to pursue debt recovery actively. It is said that bank officers at times waste almost six

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48 Kabraji, K., *Pakistan Country Report*, Paper Presented at the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 76, 81

49 Khusro Committee Report on *The Agricultural Credit System in India*, Reserve Bank of India, Bombay, 211-215

50 Interview with Dr. U. Herath, Chief Economist, Economic Research Department, Central Bank of Sri Lanka, at the Bank on 4 June 1997.

51 *World Development Report*, Oxford University Press, New York, 1989, Chapter 8

52 De Juan, A., *From Good Bankers to Bad Bankers : Ineffective Supervision and Management as Major Elements in Banking Crisis*, (Unpublished) Washington DC, 1987, 4-10

years before a decision is taken to initiate legal proceedings to recover a debt, and then expect judges and lawyers to recover the money within a year.<sup>53</sup> Credit review procedures adopted by banks may not be of a high standard.<sup>54</sup> Issues such as the risks involved in approving over-optimistic loans, excess risk concentration and inappropriate rescheduling may not be given due consideration. The accounting procedures used by lending institutions may understate the problem, and a warning of possible dangers at an early stage may go undetected.

## 1.5 SCOPE OF THE THESIS

As part of the necessary infrastructure the thesis of this dissertation is that there needs to exist fair and efficient debt recovery laws and procedures. To demonstrate this proposition the dissertation examines the law and practice of debt recovery in India, Sri Lanka and Malaysia in their social and economic contexts. These countries have been chosen for different reasons. India, because it represents one of the largest emerging economies; Sri Lanka because its relevant legal system is a mix of Common law and Roman Dutch law concepts; and Malaysia because it has achieved significant economic and financial modernisation through rather special governmental-societal approach. These countries also have similar economic and social conditions as well as a similar historical background. India, Sri Lanka, and Malaysia were British colonies until 1949, 1948 and 1957 respectively. As British colonies they inherited English legal principles, particularly commercial laws which were almost completely transplanted into their legal

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<sup>53</sup> Interview with Mr. A. Cooray, Attorney at Law, at Colombo on 28 June 1997

<sup>54</sup> Kothari, S., *Filing of Suit* (1995) 66 *The Indian Journal of the Institute of Bankers* 132, 133

systems.<sup>55</sup> It is also important to note that the national governments of all three countries are committed to developing strong market economies for sustainable growth. Hopefully, such a comparative analysis will shed some light on how to improve debt recovery laws in emerging economies in a manner conducive to sustainable economic and social development.

Chapter Two undertakes a historical review of the financial sectors from the time these three countries became independent. For each country, the financial reforms, which were considered historical landmarks, will be discussed, taking into account the political and economic backgrounds in which the reforms took place. The focus will be on banking sector reforms which had a direct impact on lending transactions. Policies on interest rates and credit controls will be dealt with in detail. The role of the central banks in implementing these policies will also be discussed.

In Chapter Three, the main features of the law and practice of credit allocation and control will be addressed. This chapter covers five aspects of credit allocation. First, the important elements of credit appraisal that are commonly accepted as good banking practice will be examined. Thereafter, obtaining credit information by lenders to assess a borrower's credit rating and the related problems will be identified. The importance of having lending agreements that provide adequate credit protection to borrowers, and at the same time not make borrowers feel vulnerable towards lenders is also considered. Loan supervision will be dealt with next. The last part of the chapter will look at the role of informal credit, key aspects of banking that affect poorer borrowers, and new

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<sup>55</sup> For example, in India the Negotiable Instruments Act, No 26 of 1881, The Sale of Goods Act, No. 3 of 1930; in Sri Lanka, the Civil Law Ordinance states that the law of England must be observed in all maritime and commercial matters. Ordinance No. 5 of 1852, Sections 2&3; In Malaysia, the Bills of Exchange Act, No. 204, 1949 & Companies Act, No. 125 of 1965

approaches to rural lending.

Chapter Four deals with the importance of credit and security in lending transactions. In each country, the range of available security, the enforcement thereof, and the problems that are encountered when enforcing security will be covered.

In Chapter Five the law and practice of debt recovery through the courts will be outlined, such as the methods available to a lender to recover its debts by initiating legal proceedings. Special attention will be given to the problem of delays, and an attempt will be made to identify the causes of delay and arrears in the courts. Possible solutions to overcome these problems will be suggested. In each of these Chapters the problems encountered by lenders will be identified and, where appropriate, possible solutions will be suggested.

Chapter Six concludes the thesis. It will look at the present state of all three banking sectors in their transition to being market economies, and the apparent tensions between the free market policies that are being ambitiously pursued, and the laws that regulate credit, security and debt recovery.

Finally, it must be mentioned that the high level of non performing loans that are currently being recorded in Malaysia due to the present East Asian financial crises is not necessarily and demonstrably an implication that the debt recovery laws in the country are inadequate or ineffective. The present situation lies in the fact that borrowers are unable to repay their debts mainly due to drastic currency devaluation and that the affected countries were suffering from a series of other macro and micro economic factors. These financial crises have therefore not been factored into this thesis.



## CHAPTER TWO

### ***CREDIT ALLOCATION AND DEBT RECOVERY: THE REFORM CONTEXT***

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- 2.1 *INTRODUCTION*
  - 2.2 *MAJOR FINANCIAL REFORMS IN INDIA - POST INDEPENDENCE YEARS*
    - 2.2.1 *Social Controls*
    - 2.2.2 *Nationalisation Of Banks - First Banking Revolution*
      - 2.2.2.1 *Effects of the Nationalisation Programme*
    - 2.2.3 *Financial Sector Reforms in 1991 - Second Banking Revolution*
      - 2.2.3.1 *Narasimham Committee Report on the Financial System*
    - 2.2.4 *Salient Features Of Financial Reforms In The Banking Sector - Post 1991*
      - 2.2.4.1 *Interest Rate Policy*
      - 2.2.4.2 *Directed Credit*
      - 2.2.4.3 *Institutional Strengthening*
  - 2.3 *ECONOMIC AND FINANCIAL REFORMS IN SRI LANKA*
    - 2.3.1 *An Open Market Economy: 1948-1956*
    - 2.3.2 *Shift Towards a Planned Economy: 1956-1965*
    - 2.3.3 *Semi-Planned Economy: 1965-1970*
    - 2.3.4 *Inward-Looking, Closed, Controlled Economy: 1970 - 1977*
    - 2.3.5 *Outward-Looking Economy with a Heavy Market Orientation*
      - 2.3.5.1 *Financial Sector Reforms*
      - 2.3.5.2 *Liberalisation of Interest Rates*
      - 2.3.5.2 *Credit Allocation*
      - 2.3.5.4 *Institutional Strengthening*
  - 2.4 *ECONOMIC AND FINANCIAL REFORMS IN MALAYSIA*
    - 2.4.1 *Interest Rate Reforms*
    - 2.4.2 *Credit Controls*
    - 2.4.3 *Institutional Strengthening*
    - 2.4.4 *Islamic Banking*
  - 2.5 *THE CENTRAL BANKS AND THEIR ROLE*
    - 2.5.1 *Monetary Instruments*
  - 2.6 *CONCLUSION*
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#### 2.1 *INTRODUCTION*

An efficient financial system contributes to positive economic development. A financial system in its role as an intermediary performs the important role of channelling savings to investment. When savings are allocated to projects that are profitable, they will result in generating high-return investments. The more investments are productive,

the higher the rate of economic growth.

Empirical evidence world-wide confirms that countries with well developed financial systems tend to have better economic performance, while countries with weak financial systems are associated with low economic performance.<sup>1</sup> Weak financial systems have certain characteristics. Interest rates are regulated by the state at negative levels and credit is directed by the state to selected sectors of the economy at subsidised low interest rates, which in turn are responsible to a great extent for the slowing of economic growth.<sup>2</sup> By contrast, in strong financial systems interest rates are determined by the respective banks without government intervention, and credit allocation depends purely on market demand. In other words, these economies have liberalised financial systems. Countries with strong financial systems also follow sound economic policies that are consistent with liberalisation, and are supported by adequate legislation and supervision.<sup>3</sup>

Transition to a market economy requires a vast reallocation of funds. The success of transition therefore depends to a great extent on the health of a country's financial system. Most developing countries that are in the process of transforming to being market economies have weak financial systems and inadequate support from the legal system. As a result they will not be in a fit state to assist in the transition process. There are no easy solutions to the problems faced by these countries. They have to find ways to overcome the old legacy of excessive government control, and at the same time

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1 *From Plan to Market : World Development Report*, World Bank, Oxford University Press, New York, 1996, 98

2 *World Development Report*, World Bank, Oxford University Press, 1989, Chapter 4

3 Zahler, R., *Financial Sector Reforms and Liberalisation*, in Faruqi, S., (Ed) *Financial Sector Reforms in Asian and Latin American Countries : Lessons of Comparative Experience*, The World Bank, Washington DC., 1993, 43, 48-50

rebuild a new system where financial institutions can function properly without government intervention. For example, a matter that will need attention is whether a government should inject funds and rehabilitate the over indebted state banks and possibly run the risk of these banks expecting government bail outs in the future, or whether a government should allow the old banks to go into liquidation and allow new banks to start afresh?

India, Sri Lanka, and Malaysia are all in the process of rebuilding their financial systems to assist in the introduction and carrying out of market reforms. When the post-colonial governments came into power, the new rulers opted to promote state-led, big development schemes rather than small private sector development projects.<sup>4</sup> This was most prominent in India and Sri Lanka. They nationalised the largest commercial banks and established new development banks for the purpose of disbursing credit to the priority sectors.<sup>5</sup> Loans to the priority sectors were granted at very low interest rates, and the governments directed the non-state banks to allocate a certain percentage of their total credit to these sectors.

Until 1991, the Indian economy was closely regulated and to a great extent uninfluenced by international trade activities.<sup>6</sup> However, by the latter part of the eighties and early nineties there was a consensus among the financial and business communities in the country that reform was long overdue.<sup>7</sup> In July 1991, India was in the middle of a

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<sup>4</sup> This appears to be the position in most countries that became independent. Long, M., *Financial Reforms : A Global Perspective* in Faruqi, S., (Ed) *Financial Sector Reforms in Asian and Latin American Countries : Lessons of Comparative Experience*, The World Bank, Washington DC, 59, 61-62

<sup>5</sup> These sectors consist of rural people with low incomes.

<sup>6</sup> Tarapore S., *Financing of Indian Industry in an Open Economy* [1995] Reserve Bank of India Bulletin 435

<sup>7</sup> Venkitaramanan, S., *Some Aspects of Banking in India* [1992] Reserve Bank of India

financial crisis when Narasimha Rao was elected Prime Minister. He turned out to be a radical reformer in liberalising the economy.<sup>8</sup> Sri Lanka moved from being an open market economy to a semi planned one, and then to an inward looking, closed and controlled economy. By 1977 the country was in economic and financial crisis. In that year President Jayawardena was elected to office, and he introduced a liberalisation programme which has progressively continued. The Malaysian economy has also undergone profound economic and financial changes. At the time of independence in 1957 it was the world's leading exporter of tin, rubber and palm oil, which commodities earned about 80% of the total export income.<sup>9</sup> It is today, one of the most industrialised nations in South East Asia. The transformation of an agricultural based economy to an industrialised one obviously required numerous policy changes. Unlike in India and Sri Lanka, the economic and financial transformation took place in a phased manner.

This chapter undertakes a historical study of the financial sector from the time that these three countries became independent. It is not intended to examine all the financial reforms that took place. To limit the scope of this study, only the reforms which had a direct impact on bank lending and debt recovery will be discussed. Emphasis will be placed on policies that have affected interest rates, credit allocation and banking institutions. Two aspects must be mentioned at the outset. First, the term "financial sector" as used here means the banking sector, because banks are the dominant financial institutions in these countries. This does not mean that non-banking financial institutions are disregarded. The second issue concerns the definition of "financial liberalisation". The

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<sup>8</sup> *The State of Reform in India*, 6th August 1994, *The Economist* 49

<sup>9</sup> Ahmad, M.S., *Chartering a Steady Course: The Economic Engineer*, 16th March 1995, *Malaysian Business* 3

term is subject to a number of interpretations. The broad interpretation given by McKinnon has been used in this study.<sup>10</sup> Accordingly, "financial liberalisation" within the banking sectors means abolishing undue reserve requirements and the lessening of government intervention with regard to interest rates and credit allocation. This may either mean eliminating state intervention<sup>11</sup> or phasing it out.<sup>12</sup>

## 2.2 MAJOR FINANCIAL REFORMS IN INDIA - POST INDEPENDENCE YEARS

India celebrated independence in 1947. The new leaders chose to rule the country based on a centrally planned development strategy, with the state playing an influential role. The government strove towards developing a society based on socialist values. This meant that the country's wealth would be distributed equitably amongst its people. The aim however, was to promote these social values through a democratic process and without making the country a totalitarian state.

The private and public sector functioned independently. The private sector was regulated by a system of licences, controls and legislative acts, while the public sector, which was wholly owned, was directly regulated by government.<sup>13</sup> The public sector expanded through the nationalisation of industries and financial institutions. For example, in 1955 the Imperial Bank was nationalised and taken over by the State Bank of India.

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10 Mckinnon, R., *Financial Liberalisation and Economic Development : A Reassessment of Interest Rate Policies in Asia and Latin America*, International Centre For Economic Growth, California, 1980, 8

11 Examples are Chile, Uruguay and Argentina

12 Examples are South Korea and Indonesia

13 Chattopadhyay, M., et al, *Planning and Economic Policy in India : Evaluation and Lessons For the Future*, Sage Publications, New Delhi, 1996, 13-14

### 2.2.1 *Social Controls*

At the time the Imperial Bank was nationalised, there were complaints that the privately owned Indian commercial banks were granting medium and large scale loans to big businesses to the virtual exclusion of the small scale borrowers, like farmers and small industrialists. It was argued that two thirds of the population lived in the rural areas and nearly three-fourths of these were below the poverty line, yet only fourteen percent of bank credit of the commercial banks was channelled to these sectors.<sup>14</sup> In response to the growing concerns over the lack of credit to the priority sectors, the government imposed controls and restrictions on the private commercial banks, so that they were compelled to provide credit to the rural sectors as well. It also issued guidelines to the banks to improve their administration and decision making process. These additional controls imposed by the government were termed ‘social controls’ and eventually found their way into legislation. The Banking Regulation Act deals with “social controls.” The preamble to the Amendment Act No. 58 of 1968 states,

*“An Act further to amend the Banking Regulation Act, 1949, so as to provide for the extension of social control over banks and for matters connected therewith or incidental thereto, and also further to amend the Reserve Bank of India Act 1934, and the State Bank of India Act, 1955.”*  
(Emphasis added)

‘Social control’ over private banks was imposed in two ways. On 22nd December 1967 the government set up the National Credit Council (NCC). The NCC was responsible for assessing the credit requirements of the various sectors of the economy, and for determining the priorities in channelling available credit. It was also entrusted with the task of co-ordinating lending and investment policies between commercial banks and

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<sup>14</sup> Tarapore, S., (Deputy Governor RBI) *Rural Banking at the Cross Roads* [1994] Reserve Bank of India Bulletin 1073-1074

co-operative banks and other specialised credit agencies.<sup>15</sup> 'Social control' was also imposed by amending the Banking Regulation Act, 1949 which introduced a number of radical amendments to control the commercial banks.<sup>16</sup> The upshot was that the government indirectly controlled the private banks and ensured the banks carried out their business according to its requirements.

### 2.2.2 *Nationalisation Of Banks - First Banking Revolution*

Six months after the second set of 'social controls' was introduced, the government decided that these controls were essentially experimental, and that it should not experiment with public funds.<sup>17</sup> On 19 July 1969, under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, fourteen large Indian private banks were nationalised.<sup>18</sup> This was considered to be the first 'banking revolution' in independent India.<sup>19</sup> This 'revolution' is historic not because of the change of bank ownership but because it was seen as an attempt by the government to pursue its objective of bringing about a socialist society.

It was hoped that the nationalisation of banks would effectively decentralise the credit granting process and have a favourable effect on the hitherto neglected sectors such as agriculture and small industries.<sup>20</sup> Nationalised banks were required to give

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15 The NCC was dissolved after the nationalisation of the commercial banks.

16 Act No. 58 of 1968, see particularly sections 10A, 10B, 20, 30, 35B, 36(1)d, 36AD, 36AE to 36AJ, and 47A

17 The major banks were operating mostly with the public deposits. Shareholder contributions were negligible. In 1968 the total deposits were 2,750 crore and the paid up capital was only 28.5 crores. [100 Lakhs = 1 Crore (i.e. 10 Million)]

18 Act No. 5 of 1970

19 Six more banks were nationalised in 1980

20 Rangarajan, C., *Imperative of Banking in India* [1994] Reserve Bank of India Bulletin 1059

priority to these sectors when allocating credit, and only use any credit surplus for new urban business enterprises. Businesses in the underdeveloped areas were to be given priority over urban industries. The state banks were also required to subsidise the priority sector by charging interest rates lower than those charged to big businesses.

The government defended its sudden decision to nationalise fourteen banks by officially taking the stand that “public ownership of the larger banks will help most effectively the mobilisation and development of national resources and its utilisation for productive purposes, in accordance with planning and priorities.”<sup>21</sup> The title to the Nationalisation Act also justifies the nationalisation of the banks: “in order to serve better the needs of development of the economy in conformity with the national policy objectives”. In other words, the government was advancing its own programme for creating a socialist society.<sup>22</sup>

The nationalisation programme was opposed by many.<sup>23</sup> They argued that the social controls had been effective for only 168 days and that this was too short a period to conclude that its objectives had failed. It was also argued that in response to the social controls imposed, the banks had willingly co-operated with the government's objectives by increasing credit to the priority sectors. For example, during this period, the twenty major banks had increased credit facilities to the agriculture sector from Rs.30 crores to Rs.97 crores and to small-scale industries from Rs.167 crores to Rs.222 crores.<sup>24</sup> Another

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21 See Preamble to The Banking Companies (Acquisition and Transfer of Undertakings Act), No. 5 of 1970

22 Gandhi, I., *Why Bank Nationalisation?* [Edited version of the Prime Minister's Speech in the Lok Sabha] (1969) 13(16) Yojana 3-4

23 Santhanam, K., *Bank Nationalisation : An Ill Considered Step* (1969) 14(7) Swarajya 13-14; Hazray, M., *Bank Nationalisation : Some Misconceptions* (1969) 14(11) 9-10; Huchappa, G., *No Justification Except Ideology* (1969) 13(17) Yojana 15-16

24 Tannan, M., *Tannan's Banking Law and Practice in India*, 19th Ed., Vol. 1, India Law



argument against nationalisation was that a switch over to the public sector was not necessary to avoid the evils revealed in the private sector. Moreover, in India public sector institutions were well known for their bureaucracy and inefficiency.<sup>25</sup> Due to lack of competition from other banks, it was said that state banks would not have the required dynamism to achieve targets.<sup>26</sup> It was also pointed out that the public sector was more open to corruption and nepotism through political influence.

#### 2.2.2.1 *Effects of the Nationalisation Programme*

Despite the wide expansion of banking facilities in terms of geographical areas, the overall performance of the nationalised banks was poor. A decline in productivity, low profitability and a high rate of non-performing loans (i.e. loans in default) threatened their viability.<sup>27</sup> The main reason for this unsatisfactory situation was the government's policy of introducing excessive central directives to commercial banks in respect of investment and credit allocations. We see below the adverse impact of this on debt recovery.

Priority sector lending was a main concern of the government. A conscious effort made by all the state banks ensured that the priority sectors received adequate resources through various credit programmes. In purely qualitative terms, these credit directives helped to achieve the government's targets on the re-direction of credit. In achieving these targets however, the banks were faced with various problems which affected their

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House, New Delhi, 1998, 131-132

25 Ghose, C., "*Bureaucratisation*" of Banks (1969) 24(29) Janata 9-10

26 Kothak, D., and Venkatachar, J., *Problems of Reorganisation* (1969) 13(22) Yojana 21; Huchappa, G., *No Justification Except Ideology* (1969) 13(17) Yojana 15-16

27 Rangarajan, C., *Inaugural Address at the 18th Bank Economists' Conference* [1995] Reserve Bank of India Bulletin 1333, 1334

profitability.<sup>28</sup> The policy of directing credit to specified priority sectors resulted in the reduction of credit to other sectors. Priority sector lending was costly due to the low interest rates that were charged and the high operating costs entailed in processing small loans.<sup>29</sup> The desire to achieve credit targets also meant that inadequate attention was devoted to the qualitative aspects of lending. Purpose based lending allowed banks a certain amount of laxity in their procedures and enabled a departure from accepted banking practices. The distinction between credit need and credit worthiness was almost confused in the minds of most bankers.<sup>30</sup>

Serious damage was done to proper credit evaluation by persistent political interference. The situation deteriorated to the extent that bank officials virtually ceased assessing the proper credit worthiness of borrowers, and granted loans to specific borrowers designated on lists prepared by government authorities.<sup>31</sup> 'Loan Melas' (fairs) conducted by politicians also had an impact on banks. Usually, *loan melas* were conducted by politicians to attract votes at elections, and entailed either undertaking to give loans at comparatively low interest rates, or the writing off of existing loans.<sup>32</sup> This procedure was quite contrary to the approved principles of professional credit appraisal, and to effective post credit supervision. Loan waivers encourage borrowers wilfully to default. As a former Governor of the Reserve Bank observed, "borrowers who are promised these

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28 According to the Governor of the RBI, after taking into account, income other than interest and allowing for provisions and contingencies, the net profit would have worked out to a deficit of one percent of working funds. Rangarajan, C., *Imperatives of Banking* [1994] RBI Bulletin 1059

29 Khusro, M., *Report of the Agricultural Credit Review Committee*, RBI, Bombay, 1993 (Reprint), 143

30 Dandekar, V., *Limits of Credit Not Credit Limits* [1993] Economic and Political Weekly A86, A91

31 Ibid., A91

32 Malhotra, R., *Rural Credit: Issues for 1990* [1990] Reserve Bank of India Bulletin 721,

concessions 'forget' to repay their loans, as they feel that the loan is given to them free by the "sarkar" (government).<sup>33</sup>

The increasing number of default loans caused grave concern to the banks. This was mainly due to the shortcomings in credit appraisal, and in supervision subsequent to granting of loans. Directing credit was considered a means to achieving the government's goals on providing credit to the priority sectors, but over the years the means seemed to have become ends in themselves.

### 2.2.3 *Financial Sector Reforms in 1991- Second Banking Revolution*

In July 1991, the government announced a new economic policy which was designed to effect important changes to revive the country's economy. The objective of the entire reform programme was to move towards a free market economy. It was hoped that pursuing these new policies would enhance the productivity and efficiency of the economy, and also increase international competitiveness. The public sector was opened to private sector participation, foreign investment was encouraged by reducing protective barriers such as high tariffs and import controls, and moderate rates of taxes were introduced.<sup>34</sup> In the reform programme, financial reforms were considered essential to make the banking sector more viable and efficient.<sup>35</sup>

33 Venkitaramanan, S., *Some Aspects of Banking in India* [1992] Reserve Bank of India Bulletin 495, 497

34 Rangarajan, C., *Banking Sector Reforms: Rationale and Relevance* [1997] Reserve Bank of India Bulletin 41-12

35 Rangarajan, C., *India Integrating into World Economy* [1994] Reserve Bank of India Bulletin 413, 415 ; Rangarajan, C., *Financial Sector Reforms and the Banking Industry* [1993] Reserve Bank of India Bulletin 987

### 2.2.3.1 *Narasimham Committee Report on the Financial System*

In August 1991, the government appointed a high powered committee under the chairmanship of Sri Narasimham, a former Governor of the Reserve Bank of India, to examine the existing financial system and suggest reforms that would make the financial sector more viable and efficient. The terms of reference were extensive. The Committee was required to examine a wide range of issues covering efficiency, accountability, profitability, modernisation, capital structure, administration and legislation including the recovery of loans. The Committee submitted its final report to the government in November 1991. The Narasimham Report was considered a comprehensive reference document for the implementation of the reform programme.<sup>36</sup>

The Committee was of the view that the need for reform in the financial sector arose from several reasons. The most important among them was the government's policy where an excessive degree of state control and direction was used in terms of investment, credit allocation, branch expansion and even the internal management aspects of the banks. Consequently, Indian banks had virtually ceased being competitive or innovative. There had also been political interference which had hindered the commercial judgement of bankers when appraising the creditworthiness of borrowers and had adversely influenced the internal management of the banks.<sup>37</sup> For the purpose of this study, attention will be focused on some of the problems that had adverse implications for the commercial banks and their lending operations.

The main cause identified by the Committee for the decline in profitability was the

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36 Tarapore, S., *Issues in Commercial Banking Reform* [1993] Reserve Bank of India Bulletin 69

37 *Narasimham Committee Report on the Financial System* 1991, Standard Book Co., New Delhi, 1992, 3-4 (hereafter *Narasimham Report*)

directed credit programmes. The Committee acknowledged that they played a useful role in extending credit to the agricultural and other small industrial sectors but was of the view that the pursuit of such objectives should use the fiscal instruments rather than the credit system. Accordingly, it suggested that the directed credit programmes be phased out. It also suggested redefining the priority sector and targeting only 10% of aggregate credit to these sectors.<sup>38</sup> The Committee recommended that concessional interest rates to priority sectors must also be phased out.<sup>39</sup>

A significant limitation on the profitability of banks was the high level of non-performing assets. Banks experienced considerable difficulties in recovering overdue debts, and the Committee considered that there was an urgent need to bring into being an appropriate legal enforcement process through which overdue loans could be recovered. It strongly recommended setting up special debt recovery tribunals on the lines proposed by the Tiwari Committee.<sup>40</sup> The Committee proposed creating a new Asset Reconstruction Fund (ARF), through special legislation if considered necessary. The main objective of establishing this Fund was to take-over the bad and doubtful debts of banking institutions and to subsequently follow up the recovery of debts from primary borrowers. The ARF would have authority to deal with the assets which were in the process of being recovered.<sup>41</sup> The Committee also believed that the balance sheets of banks should be made more transparent and that disclosures should be made in the balance sheets, as recommended by the International Accounting Standards Committee.<sup>42</sup> Important policy

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38 *Narasimham Report*, 44; At the time of submitting the report the target was 40%.

39 *Narasimham Report*, 48

40 *Narasimham Report*, 60

41 *Narasimham Report*, 61-64

42 *Narasimham Report* 59

changes were also suggested. The Committee proposed that the government should indicate that there would be no further nationalisation of banks, and that the private and public sector banks would be treated alike. This would encourage private banks to expand their operations.<sup>43</sup>

The Narasimham Committee recommendations were not only sweeping but if implemented by the government would make dramatic changes from the trends of the past two decades. The suggested reforms have been characterised as the 'second banking revolution' besides the first revolution ushered by the nationalisation programme in 1969.<sup>44</sup> The overall changes that were recommended were for greater competition and interplay of market forces in the banking sector.

While the recommendations of the Narasimham Committee were well received by the government and banking sector, concerns were raised about the likely impact of certain recommendations. Some authors have referred to the report as a "product of a professional approach which lacks any social commitment and idealism".<sup>45</sup> Kumar argued that banks played an important role in the social and rural transformation efforts and are considered one of the more effective agencies for poverty removal. With the commercialisation of the banking industry the social content of banking operations would be removed. He also argued that the Committee had failed to trace the causes which led to the nationalisation of banks and to the changes that had been made to credit policy two decades previously.

The Committee's recommendation on phasing out directed credit and lowering the

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43 *Narasimham Report* 72-73

44 Rangarajan, C., *Imperatives of Banking* [1994] Reserve Bank of India Bulletin 1059

45 Kumar, V., *Narasimham Report: A Commercial Approach* [1992] Southern Economist 8, 10

credit target to 10% of the aggregated credit was also criticised. Kumar states that directing credit to the desired sectors is a universally accepted responsibility of government, and that even in capitalist countries, subtle instruments of credit control were used. Further, if the credit target to the priority sector were reduced to 10%, significant changes would have to be made to the existing credit delivery programmes and it would be unlikely that the government would implement this recommendation because of its political implications. Finally, he questions whether the existing process could be totally reversed by reforms, and also questions whether the rural economy had reached the stage of self-sustainable growth.

It is submitted that, if the policy of extending credit to priority sectors at a concessional interest rate could render these sectors more viable economically, three decades of such preferred credit would be a sufficiently long enough period to establish its efficacy. Other than the expansion of credit in geographical terms, there is no evidence to show that directed credit programmes on their own have been successful in creating sustainable growth in the priority sectors. The high rate of non-performing loans itself is a good indication of their failure. Any benefits to the priority sectors arising from directed credit programmes should also be weighed against the resultant disadvantages caused to the general banking sector. Among a number of reasons, one important contributory factor to the diminution in profits in banks was the concessional interest rates that were charged to priority sector borrowers. It is important to understand that in a developing economy, the main purpose of credit is not necessarily poverty alleviation, and that the primary role of banks is not to act as organisations distributing low cost credit for poverty reduction. In particular, rural credit must be clearly distinguished from specific poverty alleviation programmes. As the India Agricultural Credit Review Committee has pointed out:

"In a poverty ridden economy, financial institutions do have a responsibility towards weaker sections, but it is essential to recognise the limitations of credit as the principal instrument of poverty alleviation."<sup>46</sup>

The Narasimham Committee has also confirmed this view when it opines that: "the pursuit of distributive justice should use the instrumentality of the fiscal rather than the credit system."<sup>47</sup>

#### 2.2.4 *Salient Features of Financial Reforms in the Banking Sector - Post 1991*

The overall policy thrust of the financial sector reforms after 1991 has been to create an environment in which banks have been compelled to improve productivity and reduce costs, so that they can act as autonomous business units fully responsible for their performance.<sup>48</sup> It is important to realise however that these policy changes alone were not sufficient to improve productivity. They were only a necessary prerequisite. Banks, therefore, had to respond to the changes that were introduced in an appropriate manner. Among the main variables affecting the profitability and efficiency of the banks were external constraints such as the administered structure of interest rates and credit allocation to priority sectors. Easing of these external constraints has been an important part of the reform programme.

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46 Khusro, M., *Report of the Agricultural Credit Review Committee*, RBI, Bombay, 1993 (Reprint), 979

47 *Narasimham Report* 42

48 More specifically, financial sector reforms sought to remove the external constraints that reduce the profitability of banks such as administered interest rates, improve the financial health of the banks, build the financial infrastructure relating to supervision, audit, technology and the legal framework and upgrade the internal management of banks by reviewing policies relating to recruitment and training.



#### 2.2.4.1 Interest Rate Policy

The interest rate regime in India has undergone a rapid transformation.<sup>49</sup> Before the changes were introduced interest rates were heavily regulated,<sup>50</sup> but after September 1991, the administered structure of interest rates has been gradually simplified.<sup>51</sup> In October 1995, the Reserve Bank of India, (Central Bank) abolished the minimum lending rate and directed the banks to determine their own lending rates. On the deposit side, since July 1996, the Reserve Bank has prescribed only a maximum rate for deposits up to one year.<sup>52</sup>

The interest rate policy for small loans given to the rural sector (i.e. Rs.200,000 or less) has not changed.<sup>53</sup> The government has not accepted the recommendations made by the Narasimham Committee to phase out concessional interest rates. The government appears to be of the view that the majority of the borrowers in the priority sectors would require small loans and should benefit from the concessional interest rates. If these borrowers required larger loans, then the general interest rates fixed by the respective banks should apply.<sup>54</sup> In other words, lending rates are determined according to the size of the loan.

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49 *Survey of Asian Finance : The Luck of the Bankers*, 12 November 1994, The Economist 7

50 Rangarajan, C., *Imperatives of Banking in India* [1994] Reserve Bank of India Bulletin 1059, 1061

51 Narayanan, G., *Interest Deregulation - Lending Prospects* (1998) 69 The Journal of the Indian Institute of Bankers 3

52 Rangarajan, C., *Banking Sector Reforms: Rationale and Relevance* [1997] Reserve Bank of India Bulletin 41, 43-44

53 In 1985, the Chakravarty Committee noted that, interest rates could not be left entirely to be determined by market forces and that a fair degree of regulation was necessary, but only to the extent it will not adversely affect the profitability of the banks. Chakravarty, S., *Report on the Monetary System*, RBI, Bombay, 1985, 173. The Khusro Committee agreed with this view. *Report of the Agricultural Credit Review Committee*, RBI, Bombay, 1993 (Reprint), 690

54 Rangarajan, C., *Banking Sector Reforms: Rationale and Relevance* [1997] Reserve Bank of India Bulletin 41, 45

It is submitted that the deregulation of interest rates should be extended to rural lending. When loans are granted at concessional interest rates, the practice of cross subsidisation automatically gets built into the lending operations. This means lending institutions recover the losses incurred by granting loans at concessional interest rates to certain borrowers, by charging higher interest rates to non-concessional borrowers. The Indian government considers this practice acceptable.<sup>55</sup> It is doubtful whether the practice of cross subsidisation will be effective when concessional loans are granted to priority sectors. At least two reasons may be suggested. First, the main providers of credit to the priority sectors are the regional rural banks (RRB) and co-operative banks, and these banks operate primarily in rural areas where the majority of people are poor. The number of borrowers that would fall into the non-priority sector would be very small, thus the opportunity to charge normal interest rates is very small. Second, cross subsidisation is also possible if priority sector borrowers apply for large loans. In practice, it is very unlikely that priority sector borrowers will apply for large loans, and even if they did, the banks may not consider them creditworthy.

Another problem faced by the RRB's and co-operatives is that when interest rates are fixed, particularly concessional lending rates, the difference between the lending and deposit rates are hardly adequate to cover their operational costs. The Deputy Governor of the Reserve Bank of India voiced his concern when he said:

"It is unbelievable that co-operatives and the RRB's, which had operations essentially in rural areas, were expected at one time to undertake the bulk of their lending at 10% while the maximum deposit rate was fixed at 13%. No Indian rope trick will enable a bank to be viable if the administered interest rate structure is fixed in this manner. ... The upshot of this was that the operations of the RRB's and the co-operatives came to a grinding halt and institutions which remained dedicated to their principle mandate of

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55 Ibid., 41, 43-44

lending to the rural sector incurred huge losses."<sup>56</sup>

It is a misconception to say that credit orientated to social ends must be at low cost. Lending at concessional interest rates is a case of misplaced emphasis. Research has shown that if credit were available in adequate supply, and could easily be accessed by the borrower when required, that would be more beneficial than its comparative cheapness.<sup>57</sup> Rural borrowers obtain loans from private moneylenders, even at exorbitant interest rates, because it is easier to secure credit from this source. There are no bureaucratic procedures to follow, and this means the private moneylenders are able to provide credit whenever borrowers need it.<sup>58</sup> It is paradoxical that the government is not allowing banks to charge normal interest rates to priority sector borrowers, yet the alternative of borrowing from private moneylenders at higher interest rates does not deter such borrowers.

#### 2.2.4.2 Directed Credit

In 1990, the Khusro Committee issued a comprehensive report on agricultural credit. The report dealt with a broad range of issues including strengthening the agricultural system, over-dues on agricultural loans, risks in lending, critical issues in the credit delivery system and credit linked poverty alleviation programmes. The Committee noted that mandatory lending to the priority sectors must be within limits which cross-subsidisation permits, so that the viability of the lending institutions would not be

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56 Tarapore, S., *Rural Banking at the Cross Roads*, [1994] Reserve Bank of India Bulletin 1073, 1074-75

57 Southwold-Llewellyn, S., *Some Explanations for the Lack of Borrower Commitment to Specialised Farm Credit Institution: A Case Study of the Role of Rural Sri Lankan Traders in Meeting Credit Needs* (1995) 15 Savings and Development 290-291; See Chapter 3 *Credit Allocation and Loan Monitoring*

58 Narula, R., and Gopalakrishnan, V., *Agricultural and Rural Advances by Commercial Banks*, U.D.H Publishers, New Delhi, 1982, 36

adversely affected.<sup>59</sup>

The Narasimham Committee was of the same view but went further and said that the directed credit target for the priority sectors should be reduced to 10%. The government, however, did not accept this recommendation. Directed credit continues to play a significant role in the main poverty alleviation programmes. The Reserve Bank has laid down that 40% of net bank credit should be given to the priority sectors such as agriculture, small-scale industries, and small businesses. According to the latest figures that are available, public sector banks lent 41.7% of their net credit to the priority sectors, an excess of 1.7% of the prescribed target.<sup>60</sup> To assist directed lending, the government has introduced a Rural Infrastructure and Development Fund (RDIF) and the Khadi and Village Industries Commission to disburse credit.<sup>61</sup>

#### 2.2.4.3 Institutional Strengthening

The financial reforms also aimed at strengthening banking institutions, particularly, the public sector banks. The Government and the Reserve Bank jointly launched an aggressive reform package which primarily dealt with re-capitalisation, improving the quality of loan portfolios, instilling a greater element of competition, and strengthening the supervisory process.

During the last three years the government has injected about Rs.12,000 crore to the public sector banks. An important element of the restructuring programme was to reduce non-performing assets. In fact, capital allocations have been made conditional on

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<sup>59</sup> Khusro, M., *Report of the Agricultural Credit Review Committee*, RBI, Bombay, 1993, (Reprint) 1072

<sup>60</sup> Reserve Bank of India Annual Report, 1996, 12

<sup>61</sup> *Reserve Bank of India Report on Trend and Progress of Banking in India 1994-1995*, RBI, Bombay, 1996, 12 ; Rangarajan, C., *Banking Sector Reforms: Rationale and*

the banks drawing up business restructuring plans aimed at achieving viability over the next 2-3 years.

In 1995, the Reserve Bank announced the Banking Ombudsman Scheme under the provisions of the Banking Regulations Act, 1949. The scheme is designed to deal effectively with the grievances of customers in an expeditious and inexpensive manner. The scheme covers all commercial banks except rural regional banks and co-operatives. Three banking ombudsman centres have been established and five more centres were announced in 1995.<sup>62</sup> The use of technology has also been introduced and steps have been taken to have some branches fully automated.

Following the recommendations of the Narasimham Committee, the Reserve Bank has taken steps to supervise the banks more effectively. To do this, the Bank has set up a separate Board for Financial Supervision (BFS) which concentrates on compliance with regulations and guidelines in the areas of credit management, asset classification, income recognition, capital adequacy, provisioning of bad and doubtful debts and treasury options.<sup>63</sup>

So far, the reform process in India has achieved positive results. The overall performance of banks has improved significantly and is clearly reflected in the balance sheets of the banks. The reason for its success has been the cautious and phased introduction of the reforms and their collective enforcement. In the year 1992-93 the non-performing assets amounted to 23.2% of total loan assets. After the restructuring programme was initiated the figure had come down to 13.5 in 1996-97. These figures

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*Relevance* [1997] Reserve Bank of India Bulletin 41,48

62 *Reserve Bank of India Trend and Progress of Banking in India 1994-1995*, RBI, Bombay, 1996, 13

63 *Ibid.*, 8-9

show that the reforms that were introduced are yielding results. However, it must not be forgotten that only 86.5% of the assets portfolio are generating a return income. It is of paramount importance that banks endeavour to reduce the non-performing assets to at least 10% in the immediate future. Ideally this figure should be no more than 5%. Although statistical data show that the performance of the banks has improved, there are a number of areas in which weaknesses still persist. There is scope for the internal operations of the banks to be further improved, as well as customer services. More resources should be allocated to technological upgrading, and credit appraisal should become more professional.

### 2.3 *ECONOMIC AND FINANCIAL REFORMS IN SRI LANKA*

Sri Lanka became independent in 1948. The independence movement was free from controversy, and the transfer of power was peaceful. The economy was stable and the standard of living of the people was well above that of its neighbouring countries.<sup>64</sup> A widely held view was that of all post-colonial nations, Sri Lanka would prove "the best bet in Asia".<sup>65</sup>

Even before independence, Sri Lanka had been committed to maintaining a welfare state. The economic depression in the 1930's had prompted the British administration to introduce a series of social welfare measures to assist the worst effects of the depression. This move became an established welfare system that was continued after independence. Sri Lankans were provided with food subsidies, free health care and free

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<sup>64</sup> Bruton, H. J., *The Political Economy of Poverty, Equity and Growth : Malaysia and Sri Lanka*, Oxford University Press, New York, 1992, 329

<sup>65</sup> Jiggins, J., *Dismantling Welfarism in Sri Lanka* [1976] Overseas Development Institute Review 2

education up to university level.<sup>66</sup> The welfare system was an integral part of Sri Lanka's economy, and any attempt to reduce or remove subsidies was met with a public outcry. The issue of food subsidies was always an important concern during general elections, and the political parties exploited it to win elections. It is therefore prudent to explain the important role the social welfare system played in economic and financial reforms. Compared with the systems prevalent in India and Malaysia, the welfare system in Sri Lanka, although based on social needs was also tempered by political and financial exigencies.

### 2.3.1 *An Open Market Economy: 1948-1956*

During this period, the country followed a free enterprise liberal framework with little or no government control in economic activities. Inflation was kept under control, and foreign investment was encouraged. There was minimum state intervention in foreign trade, and in exchange control.<sup>67</sup> Direct state involvement to expand the manufacturing industries was not a priority and a number of unprofitable industries were closed down. Privatisation was very much on the agenda.<sup>68</sup>

During this period, foreign banks dominated the commercial banking sector. These banks were primarily concerned with financing the plantation sector which was totally private. The two indigenous banks played a very low key in financial activities, and

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<sup>66</sup> UNICEF, Sri Lanka: *The Social Impact of Economic Policies During the Last Decade* in Cornia, G., et al, *Adjustment With a Human Face*, Vol. 2, Clarendon Press, Oxford, 1989, 238

<sup>67</sup> Karunasena, A., *Monetary Policy in Sri Lanka: An Update* in Talib, A., *Monetary Policy in SEACEN Countries*, SEACEN Research and Training Centre, Kuala Lumpur, 1993, 443

<sup>68</sup> As a first move towards privatisation, the government passed legislation that allowed government-owned industries to be converted into public corporations. Athukorala, P., and Jayasuriya, S., *Macroeconomic Policies, Crises and Growth in Sri Lanka 1969-*

as a result the informal moneylenders thrived.<sup>69</sup>

Although the government followed these liberal policies welfare expenditure was increasing the fiscal deficit. The government decided, consequently, to raise the price of rice as well as public utility charges. Free meals for school children were also abolished. As a direct result of these welfare cuts, the ruling United National Party (UNP) suffered a landslide defeat at the next general election.

### 2.3.2 *Shift Towards a Planned Economy: 1956-1965*

The Sri Lanka Freedom Party (SLFP), which was socialist, formed the new government. It nationalised all foreign-owned plantations and took control of key industries in the manufacturing sector.<sup>70</sup> The bus services and the cargo handling section in the port of Colombo were also taken under government control. Banking and insurance companies were not spared either.

In 1961 two important reforms were introduced to the financial sector. One was the nationalisation of the Bank of Ceylon, the largest domestic bank, and the second was the opening of a new state owned bank called the Peoples' Bank.<sup>71</sup> The main objective of these reforms was to increase credit to the priority sectors and also provide better banking services to rural areas. The government directed both the state banks to lend at concessional interest rates, and these rates were fixed for specific sectors of the population. There was also a drive to expand banking services to the rural areas. Between 1960-1965,

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1990, World Bank, Washington DC, 1994, 9-10

<sup>69</sup> Tilakaratna, W., *Agricultural Credit in a Developing Country - Ceylon*, Central Bank of Ceylon, Colombo, 1963, 100-120

<sup>70</sup> State Industrial Corporation Act, No. 49 of 1957, *Legislative Enactment's of Sri Lanka (Revised 1980)* Cap. 208

<sup>71</sup> Act No. 29 of 1961



the number of branch offices in the two state banks increased from 45 to 97, and by the end of 1965 the two state banks held two thirds of all bank deposits. In both countries, India and Sri Lanka, the government's policy on nationalisation was similar. In terms of branch expansion, the overall results were favourable in both countries.

By the end of 1965, the people of Sri Lanka had experienced economic difficulties under both governments that had been elected after independence. While the UNP had been responsible for cuts in the welfare system, the SLFP embarked upon a policy of drastic import restrictions to foster local industries. In the ensuing election, in 1965, neither party won an overall majority and the UNP formed a coalition with another party.

### 2.3.3 *Semi-Planned Economy: 1965-1970*

Once again, the government took steps to liberalise the economy, but this time more cautiously. The government was hesitant to take steps that would achieve a full-scale liberalisation because it was aware of the anti-government feeling that would be aroused if consumer subsidies were cut. The economic climate improved, and the government's ambitious plans for food production appeared to be realistic. Once again, the UNP reduced the amount of rice available at a subsidised price. The voters did not forgive the government for this move, so the UNP was defeated at the next general election. The defeated UNP leader is known to have commented that by tampering with the rice subsidy for the second time in his political career, he had paid the penalty for "disturbing the most cherished of Sri Lanka's sacred cows."<sup>72</sup>

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<sup>72</sup> De Silva, K., *A History of Sri Lanka*, Oxford University Press, New Delhi, 1981, 539

### 2.3.4 *Inward-Looking, Closed, Controlled Economy: 1970 - 1977*

The new United Front Government (UF) consisted of three parties. The Sri Lanka Freedom Party (SLFP) was committed to state controls and the Lanka Sama Samaja Party (LSSP) and Communist Party (CP) gave high priority to equity issues and were against large-scale foreign borrowing that involved conditionality. Party leaders did not want to be dictated to by the IMF and the World Bank. The UF's objective was to "lay the foundation for the building up of a socialist society."<sup>73</sup> The focus of economic policy was very much the same as before. Most of the plantation sector was taken over by the state under the Land Reform Act.<sup>74</sup> The government also acquired any business undertaking under the Business Undertakings Acquisition Act, if it were considered to be in the "national interest."<sup>75</sup> More exchange controls were imposed by the Exchange Control Act. The Act also prohibited Sri Lankans from opening or maintaining foreign bank accounts, and remitting money abroad without prior permission from the exchange control authorities.

On the welfare front, despite election pledges to the contrary, the government was forced to cut down the subsidies and the rice ration was reduced. Essential imports also rose in price, as well as the cost of public utilities. By 1975 the economic hardships faced by the people were tremendous and mass opposition to the government was growing.<sup>76</sup> It was in this environment that the UNP campaigned for a fully liberalised

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73 Perera, N., (Minister of Finance) *Budget Speech*, Department of Finance, Colombo, 1970, 3

74 Under the Land Reform Act, 1972 (as amended in 1975), 63% of the tea plantations, 32% of the area planted with rubber and 10% of the area cultivated with coconut were nationalised.

75 Act No. 35 of 1971, *Legislative Enactments of Sri Lanka (Revised)*, 1980, Cap. 184; By 1977, 26 businesses had been acquired by the government under this Act.

76 The author recalls some of the hardships. A family of five was allowed to buy two

economy, and argued that lifting the trade restrictions would end the existing shortages and hardships. It dared not, however, remove food subsidies but instead promised to introduce a food stamp programme by which the poor people would be given stamps that entitled them to food and kerosene to the value of the stamps. The message appealed to the voters, and in 1977 the UNP won the general elections with a two-thirds majority in parliament.

### 2.3.5 *Outward-Looking Economy with a Heavy Market Orientation : 1977-*

The new government introduced a wide-ranging programme of reforms that represented a significant reorientation of economic policy.<sup>77</sup> Essentially, the new policies were aimed at transforming the Sri Lankan economy away from an inward-looking, closed and controlled economy to an outward-looking, open market economy.<sup>78</sup>

The system of quotas, licences and controls was removed and a more realistic system of tariffs was introduced. Price controls were abolished and food subsidies were replaced by 'food stamps' for about half the country's population. State sector monopolies were also removed.<sup>79</sup> Foreign exchange controls were abolished and replaced with a

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pounds of bread a day. Rice could be eaten only three days of the week (usually rice is eaten every day). A person was allowed a pound of sugar for the month and special coupons were provided to buy cloth.

77 De Mel, R., (Minister of Finance) *Budget Speech 1978*, Minister of Finance, Colombo, 1977, 1-10

78 These policy reforms have been the subject of substantial research. See Rajapathirana, S., *Foreign Trade and Economic Development : The Case of Sri Lanka*, (1988) 16 *World Development* 43-57; Athukorala, A., and Rajapathirana, S., *The Domestic Financial Market and the Trade Liberalisation Outcome: The Evidence from Sri Lanka*, World Bank Policy, Research and External Affairs Working Papers (WPS590), World Bank, Washington DC, 1990 ; Cuthbertson, A., & Athukorala, P., *Sri Lanka in Papageorgiou, D., Michaely, M., and Choksi, A., (Eds.) Liberalising Foreign Trade: Indonesia, Pakistan and Sri Lanka*, Basil Blackwell, Oxford, 1990

79 UNICEF, *Sri Lanka: The Social Impact of Economic Policies During the Last Decade* in Cornia, G., *Adjustment with a Human Face*, Clarendon Press, Oxford, 1989, 238

floating exchange rate system. The government called for private sector participation in the economic development of the country and removed the fears of further nationalisation. These open market policies encouraged foreign investment. The Western powers and international agencies also showed their approval of the sweeping reforms being implemented by granting an unprecedented flow of aid.<sup>80</sup>

#### 2.3.5.1 *Financial Sector Reforms*

The objective of financial sector reforms was to create an efficient, dynamic financial system in accordance with financial sector developments in the rest of the world. The government removed all restrictions that hampered the development of the financial system. Foreign banks of good repute were invited to open branches in Sri Lanka and consequently, twelve foreign banks established branches in the country. The new banks brought with them innovative techniques and practices in banking and advanced information technology. By the end of 1982, fourteen new foreign banks had established branches in the country and by 1990 had captured more than 10% of the market share. The banks were also allowed to open branches in the outstations and as a result, the average number of customers with any one bank decreased from 30,000 in 1980 to 23,000 in 1990.<sup>81</sup>

In addition to these deregulatory measures, the reforms included liberalisation of interest rates and credit allocation, the strengthening of the legal, accounting, regulatory and administrative frameworks of financial institutions and monetary management based

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<sup>80</sup> Levy, B., *Economic Aid in the Making of Economic Policy in Sri Lanka*, World Bank, Washington DC, 1995

<sup>81</sup> Karunasena, A., *Monetary Policy in Sri Lanka : An Update* in Talib, A., *Monetary Policy in the SEACEN Countries : An Update*, SEACEN Research and Training Centre, Kuala Lumpur, 1993, 450

on market-orientated policies.<sup>82</sup> No doubt, all these reforms are important to create a liberal financial system but in this study, as mentioned before, emphasis would be on interest rate liberalisation, credit allocation and the administration of banking institutions.

#### 2.3.5.2 *Liberalisation of Interest Rates*

This was perhaps, one of the most important reforms that were introduced. The new policy allowed interest rates to be determined by market conditions, but its effectiveness was limited in the early stages of the reform process. In an attempt to liberalise interest rates, in January 1982, interest rates on priority sector loans were increased from 15% to 18% and then to 20% in November the same year. Due to the increase in interest rates there was a dramatic decline in the number of loan applications from borrowers in these sectors and in 1983, the government decided to revise the interest rate down to 14%. Government decisions like this show that at the beginning, only a half-hearted attempt at liberalising the interest rates was made.

In 1988, a more positive move was taken by the government when it introduced a new policy to determine the interest rate on small and medium loans, whereby a variable interest rate was charged based on the “prevailing average weighted prime rate” (PWPR). Accordingly, the interest rate that was charged reflected both the cost of funds and the risk element. A project that reflected a high risk was charged a high interest rate and conversely, a lower rate was charged for a low risk project.<sup>83</sup> The application of this policy was more in line with market-determined interest rates and does not distort the liberalised interest rate structure. The Presidential Commission on Finance and Banking endorsed this

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82 Ibid., 449

83 Amarakoon Bandara, A., *Financing for SMI's in Sri Lanka*, in Junggun Oh, *Financing for Small and Medium Scale Industries in the SEACEN Countries*, SEACEN Research

policy when it stated:

“Rates of interest computed on the basis of risk and the high overhead costs of small enterprise lending are bound to be higher than for large scale lending. It is suggested that credit be made available to small borrowers at market rates which makes such lending a viable proposition for banks.”<sup>84</sup>

However, it must be noted that the government provides an interest rate subsidy for agricultural loans under the New Comprehensive Rural Credit Scheme.

Although market conditions are required to determine the level and structure of interest rates, in practice the Central Bank continues to signal changes in the interest rates charged by commercial banks. This is done in a number of ways. The government's own securities are treasury bills, and the rate on these is usually fixed by the Central Bank. The treasury bill rate represents the lower end of the range of what the Central Bank considers to be the desired interest rate. Further the National Savings Bank<sup>85</sup> fixes its deposit rates under the guidance of the Central Bank. The same practice is followed by other state owned banks.<sup>86</sup> Clearly, the state banks operate under the guidance of the Central Bank and as a result the interest rates that are being charged are within the range the Central Bank and the government prefers.<sup>87</sup>

### 2.3.5.3 Credit Allocation

Prior to 1977, there were a number of credit schemes that were designed to direct

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and Training Centre, Kuala Lumpur, 1994, 325

84 *Report of the Presidential Commission on Finance and Banking*, Vol. 1, Department of Government Printing, Colombo, 1992, 128

85 This bank was established by the State to co-ordinate and develop savings in the country.

86 Jayamaha, R., and Wilson, P., *Development Banking in Sri Lanka: Coercion or Moral Suasion?* (1991) 9 *International Journal of Development Banking* 3, 6

87 Yoon-Je Cho and Deena Khatkhate, *Lessons of Financial Liberalisation in Asia, A Comparative Study*, World Bank Discussion Papers, World Bank, Washington DC, 1989, 44, 50

credit to certain sectors of the population. Until 1980 the Central Bank prepared a "National Credit Plan" in consultation with the commercial banks which was put into operation every year.<sup>88</sup> The Central Bank also operated a number of refinancing schemes to encourage banks to lend to specific sectors that were starved of institutional credit.<sup>89</sup> If there were loan defaults, the Central Bank had a scheme known as the "Credit Guarantee Scheme" where a percentage of the defaulted money was reimbursed to the banks. The reason only a percentage was given was because if the entire amount was recoverable by the guarantee scheme, then there would be no incentive for banks to make an all out effort to recover the unpaid loans.

Clearly, these schemes were inconsistent with the new market orientated economic and financial policies the government was pursuing. Further, refinancing schemes increased the money supply which undoubtedly allowed inflation to rise. It was also felt by the Central Bank that refinancing was in fact a form of subsidy, which was not acknowledged as a subsidy and therefore did not encourage transparency of the Bank's operations. By 1990, the "National Credit Plans" as well as the refinancing schemes were discontinued by the Central Bank.<sup>90</sup>

Although the Central Bank took these steps, the government was keen to find out

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88 Interview with Dr U., Hearth, Senior Economist, Central Bank of Sri Lanka, at the Central Bank Head Quarters, Colombo, on 4 June 1997.

89 Refinance schemes were operated when the Central Bank was of the view that a certain sector needed additional credit facilities. It provided the banks with a certain percentage of the funds to be lent by the banks to the identified sector. The banks had to put the balance funds.

90 The Presidential Commission on Finance and Banking suggested to revive the 'National Credit Plan' as an indicative credit programme rather than a mandatory method of credit allocation. *Second Interim Report on Allocating Resources to Priority or Weaker Sectors and Channelling Credit to the Poor*, Department of Government Printing, Colombo, 1992, 58; *Ninth Interim Report on The Central Bank of Sri Lanka*, Department of Government Printing, Sri Lanka, 1992, 48

if mandatory credit allocation in favour of the weaker sectors could be continued.<sup>91</sup> In 1991, the President appointed a commission to study and report on the matter. The Commission advised the government against mandatory allocation of credit and government directed credit programmes. A number of reasons were given in support of their view.<sup>92</sup> First, it was of the view that mandatory credit allocation can be successful in reaching lending targets but not in maintaining adequate rates of loan recovery. The Indian experience was given as an example. Second, mandatory credit allocation would inevitably reduce the supply of credit to more productive sectors which have to bear higher borrowing costs. Third, the realisation of other objectives such as competitiveness, efficiency and internationalisation of banking operations may be rendered difficult. Fourth, a mandatory approach may adversely affect the viability of banking institutions and finally, the true degree of compliance with mandatory allocation was difficult to monitor. It was also noted that the Central Bank considered moral suasion was more appropriate than a mandatory approach.<sup>93</sup>

The Commission also proposed, *inter alia*, setting up a "credit co-ordinating and monitoring committee" to assist in the disbursement of credit to the weaker sectors. The Committee would consist of representatives from all the institutions that were involved in lending to the poor.<sup>94</sup> This Committee was set up by the government.

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91 During the period 1989-1993, there was tension between efforts to pursue a stabilisation and liberalisation programme and the politicians perception of what liberalisation should provide in terms of government support and distribution gains. See - Durham, D., and Kelegama, S., *Economic Reform and Governance: The Second Wave of Liberalisation in Sri Lanka, 1989-1993*, Institute of Policy Studies, Colombo, 1995, 19

92 *Second Interim Report on Finance and Banking: Allocating Resources to Priority or Weaker Sectors and Channelling Credit to the Poor*, Department of Government Printing, Colombo, 1991, 43-44

93 *Ibid.*, 42

94 *Final Report of The Presidential Commission on Finance and Banking*, Vol.1,



The current position on credit allocation is that banks are left to create their own schemes to provide credit without central bank intervention. The state banks disburse credit through a number of credit schemes. The Praja Naya Niyamakas, (Peoples' Loan Scheme – PNN) lending with the assistance of non-governmental organisations, lending through the National Youth Services Council (NYSCO), and the Janasaviya programme, (strength of the people) are some examples.<sup>95</sup>

#### 2.3.5.4 *Institutional Strengthening*

The new financial reforms, which were introduced in Sri Lanka, also concentrated on improving the efficiency of lending institutions, particularly, the state-owned banks. Research showed that a considerable amount of work had been done to find out the underlying problems, and numerous efforts were made to improve the performance of the banks ranging from financial restructuring to managerial reforms. In 1991, the Presidential Commission on Finance and Banking in its Seventh Interim Report, studied the problems faced by commercial banks and other deposit taking institutions and made several recommendations. Some of the reforms related to the boards of directors and management, administration, lending operations, legal proceedings and accountability and audit requirements.<sup>96</sup> The Commission suggested that as an institutional arrangement for debt recovery, a separate institution or institutions be entrusted to deal with the task of collecting debts and, where possible, the rehabilitation of debtors. The Commission justified their recommendation by stating that past experience indicated that the two state

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Department of Government Printing, Sri Lanka, 1992, 123

<sup>95</sup> Sanderatne, N., *Banking for the Poor*, (1991) 17 *Economic Review* 2, 4; Watawala, L., *Financial Innovations for the Rural Poor: The Asian Experience*, (1991) 17 *Economic Review* 5, 6-8, 15

<sup>96</sup> *Seventh Interim Report on Finance and Banking on Commercial Banks and Other*

banks have not been able to collect bad debts in an effective manner due to external interference and laxity within the banks.<sup>97</sup> The government did not accept this recommendation.

The Commission also recommended that banks must be free of government control and is allowed to act independently in all financial and administrative matters.<sup>98</sup> If the government requested the granting of loans which the bank considered to be non-viable, or lending at interest rates below the market rates to particular groups of borrowers, then the government must compensate the banks for the notional loss of income. The government accepted both these recommendations.<sup>99</sup>

Over a period of time, the quality of service provided by the state banks appears to have deteriorated. A number of reasons may be suggested. The lending policies adopted by these banks are rather bureaucratic and cumbersome, which delays the processing of loan applications. The administration of the banks appears to be lethargic and the staff lack motivation. The quality of management is also weak.<sup>100</sup> Officers involved in credit processing do not have clearly defined responsibilities and are not held accountable for their decisions. Inadequacy of trained staff is a problem. The reason for this is the resignation of trained staff to join foreign and private banks and other financial institutions. Their age also makes it difficult to train some staff officers in new skills.<sup>101</sup> With a view to developing manpower skills in the banking sector, the Presidential

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*Deposit Taking Institutions*, Department of Government Printing, Sri Lanka, 1992

97 Ibid., 29-34

98 Ibid., 42

99 Treasury circular dated 22 April 1992 provides for a relaxation of government controls on the management and operations of the state banks. It also agrees to subsidise guarantee loans that have been granted under its direction.

100 Ibid., foot note 96, 43

101 Nanayakkara, R., *Commercial Banking Views* [1994] Economic Review 24

Commission suggested that the Central Bank should attempt to strengthen the Institute of Bankers of Sri Lanka or if that was not possible, it should explore the feasibility of setting up a new Bankers Training Institute.<sup>102</sup>

The Monetary Act provides the Central Bank with powers, functions and responsibilities necessary for the administration and regulation of all banking institutions in the country. The Department of Bank Supervision in the Central Bank was established under the Monetary Act for this purpose.<sup>103</sup> Although a statutory framework is available to regulate banking operations the Central Bank has failed to carry out its supervisory role effectively, once again due to the loss of trained bank supervisors to foreign banks.<sup>104</sup>

The Presidential Commission was of the view that bank customers with grievances must be given the opportunity to have their complaints dealt with expeditiously outside the normal judicial system. It therefore suggested the establishment of a scheme for a banking ombudsman similar to the one in the United Kingdom.<sup>105</sup> In addition, it suggested drafting a 'Code of Conduct' for banks, and the enactment of a 'fair banking practice law'<sup>106</sup> and an 'unfair contracts law.'<sup>107</sup>

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102 *Seventh Interim Report on Commercial Banks and Other Deposit Taking Institutions*, Department of Government Printing, Colombo, 1992, xvii

103 Sections 28-31, Monetary Law Act No 33 of 1954 (as amended) ; *The Legislative Enactment's of Ceylon, (Revised 1980)* Cap 422 ; See generally De Juan, A., *From Good Bankers to Bad Bankers : Ineffective Supervision and Management Deterioration as Major Elements in Banking Crises*, World Bank, Washington DC, 1987

104 *Ninth Interim Report on the Central Bank of Sri Lanka*, Department of Government Printing, Colombo, 1992, 75

105 *Seventh Interim Report on Commercial Banks and Other Deposit Taking Institutions*, Department of Government Printing, Colombo, 1992, 92-93 ; *Third Interim Report on Debt Recovery Legislation*, Department of Government Printing, Colombo, 1992, 26-27

106 In the United Kingdom, a voluntary code known as "Good Banking" came into force in 1992. The Code is reviewed periodically. The need for such a code was raised in the U.K. by a committee reviewing the banking services; Report, Jack, R., *Banking Services : Law & Practice*. CM622, HMSO, 1989, 377-383 ; Jack, R., *Report of The Review Committee*, Cm1026, HMSO, London, 1990, 7-13 ; The same issue was

Eighteen years after the new financial policies were introduced and three years after the Presidential Commission made numerous recommendations to improve the financial sector, the World Bank in one of its research reports observed:

“The main constraint that remains is the dominance of inefficient state-owned banks... The resultant lack of competitive pressure has reduced both the level and quality of financial intermediation. Quality has suffered due to two reasons. First they have been used as instruments of government policy to direct credit to politically determined beneficiaries, often without regard to financial or economic viability. Second, these banks have played the role of the market makers in determining domestic lending rates. Consequently, while inefficiency resulting from over-staffing and bad portfolio has raised the cost of doing business the effect of these inefficiencies have often been passed on the borrowers in terms of higher loan rates.”<sup>108</sup>

The problems noted in the World Bank report are still continuing. A question that must be raised is whether privatising the state banks would increase the profitability and dynamism of the state banks.<sup>109</sup> The World Bank favours this option.<sup>110</sup> The Banking and Finance Commission considered this matter generally and was of the view that privatisation is not a practical option at present.<sup>111</sup> It is submitted that the option of privatising the two state banks must be seriously considered. So far, the remedies that have been suggested to overcome the financial difficulties faced by these banks have not been successful. The reason for this is that the main cause for the financial difficulties faced by

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considered by a committee in Australia as well; Martin, S., *A pocket Full of Change : Banking and Deregulation*, Australian Government Publishing Service, Canberra, 1991, 381-390

107 *Seventh Interim Report on Commercial Banks and Other Deposit Taking Institutions*, Department of Government Printing, Colombo, 1992, 92

108 Ahamed, S., Ranjan, P., *Promoting Growth in Sri Lanka*, World Bank, Washington DC, 1995, 28

109 Interview with Mr. M. Fernando, Manager, Credit Department of the Peoples' Bank, at the bank's Head Quarters, on 14 May 1997; Interview with Dr U. Herath, Chief Economist, Central bank of Sri Lanka, at the Central Bank, on 4 June 1997

110 Ahamed, S., Ranjan, P., *Promoting Growth in Sri Lanka*, World Bank, Washington DC, 1995, 28

111 *Seventh Interim Report on Commercial Banks and Other Deposit Taking Institutions*,

the banks, i.e. the non viable and non recoverable loans that are being granted have so far not been given serious consideration, possibly, because it is politically sensitive. If the banks are privatised, this problem may be resolved because it is unlikely that shareholders will tolerate government intervention of this nature. Examples may be taken from other private banks operating in the country. These banks are efficient, competitive and operate profitably. The consequences of an important reform such as privatisation would affect the entire banking industry, because the state banks account for over 68% of the banking operations in the country. It is therefore vital that a committee of experts carefully considers this option before the government considers its implementation.

#### 2.4 *ECONOMIC AND FINANCIAL REFORMS IN MALAYSIA*

Malaysia became an independent state in 1957. The colonial experience was reasonably amicable and independence was implemented quite harmoniously. Malaysian nationals had been in government before independence and as a result, the new leaders were familiar with the British approach towards handling economic activities.<sup>112</sup>

At the time of independence, Malaysia was the world's leading exporter of tin, rubber and palm oil, which commodities accounted for about 80% of the country's foreign earnings. Over the years the manufacturing sector expanded rapidly, and now it accounts for 70% of export earnings. The nation's dependence on tin and rubber had shrunk to a mere 2% of total exports by the end of 1994.<sup>113</sup> The transformation of the agricultural based economy to an industrialised one required numerous policy changes. The changes

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Department of Government Printing, 1992, 21

112 Bruton, H., *The Political Economy of Poverty, Equity and Growth, Sri Lanka and Malaysia*, World Bank, Washington DC., 1991, 329

113 Ahmad, M.S., *Chartering a Steady Course: The Economic Engineer*, 16 March 1995, Malaysian Business 3

took place gradually and as a result, the economic and financial transformation was relatively smooth. On the other hand, there were dramatic changes which indirectly affected the economic and financial activities of the country.

After independence, economic development was given priority and the government concentrated on improving the economy of the country. Little attention was given to the growing disenchantment of the Malay population.<sup>114</sup> Evidence showed that the economic position of Malays was significantly inferior to that of non-Malays. More than half the population was of Malay origin, but almost 80% of Malays worked in the rural areas. In the urban areas non-Malays held 75% of the jobs and the Malays were very poorly represented in managerial and supervisory positions. In the corporate sector, the proportion of share capital of limited companies held by Malays was only 2%. The Chinese community held about one third of the share capital and the balance was held by foreigners. The Chinese land holdings were also on average, twice the size of Malay land holdings. The frustrations of Malays broke out during the elections in May 1969 when the candidates campaigning for the interests of the non-Malays performed better. Riots rocked the capital and Parliament was suspended. The army and police restored civil order.<sup>115</sup>

Malaysian political leaders were forced to recognise the dangers inherent in a multiracial society when ethnic prejudices were exacerbated by economic disparities.<sup>116</sup> The rules for governance had to change. First, the new government officially identified the Malays as the "Bumiputeras" (sons of the soil). Then, it introduced the "New Economic

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114 Malaysia has a multiracial society. It consists of those of Malay (i.e. the indigenous people), Chinese and Indian decent.

115 Rasiah, R., Class, Ethnicity and Economic Development in Malaysia, in Rodan, G., (Eds.) et al, *The Political Economy of South-East Asia*, Oxford University Press, Melbourne, 1997, 121, 122

116 Young, K., et al, *Growth and Equity in a Multiracial Society*, A World Bank Country Economic Report, The Johns Hopkins University Press, London, 1980, 19-22

Policy” which established long term targets to reduce poverty and to increase Malay participation in economic activities.<sup>117</sup> Since 1970, economic and financial policies have always taken a special interest in the Bumiputera community. The position remains the same today.<sup>118</sup> Extending such special considerations to a particular group of people as a matter of state policy is a peculiar feature of Malaysia. During my visit to the country, it was clear to me that there was considerable hostility among the minority groups towards the special privileges that are afforded to the Bumiputeras but minority groups have come to accept it.

The emergence of the industrial sector introduced policies which were market orientated and outward looking. Compared with Sri Lanka, policy implementation in Malaysia was relatively trouble free. The most obvious reason that can be given is that since independence, the country had been governed by a single coalition party now known as the National Front. The dominant party is the United Malay National Organisation (UMNO) but there are almost a dozen other parties. Compared with various Sri Lankan governments that ruled the country until 1977, the Malaysian government did not have to worry about losing elections. However, the fact that a single party had a firm hold on the government did not necessarily simplify the implementation of important policy changes.<sup>119</sup> To achieve consensus among the majority of the coalition party was extremely difficult because it represented a diversity of interests and ideas.

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117 Rasiah, R., Class, Ethnicity and Economic Development in Malaysia, in Rodan, G., (Eds.) et al, *The Political Economy of South-East Asia*, Oxford University Press, Melbourne, 1997, 121, 126-127; Faaland, J., et al., *Growth and Ethnic Inequality, Malaysia's New Economic Policy*, Hurst and Co., London, 1990, 8-15

118 The Bumiputera Industrial Fund, The ASB- Loan Scheme for Bumiputera Hard-core Poor, New Entrepreneurs Fund are all administered by the Central Bank to promote economic development in the Bumiputera community. These are only a few examples.

119 Bruton, H., *The Political Economy of Poverty, Equity and Growth : Sri Lanka and Malaysia*, World Bank, Washington DC, 1991, 348

Towards the end of 1978, the government decided to liberalise the financial system. Unlike India and Sri Lanka, the decision was taken at a time when the Malaysian economy was quite stable.<sup>120</sup> Prior to liberalisation, the government had imposed strict interest rate restrictions, domestic credit controls, and maintained high reserve requirements.

#### 2.4.1 Interest Rate Reforms

Bank Negara Malaysia (Malaysia's Central Bank) has the power to make recommendations to banking and other financial institutions regarding the interest rates that may be charged or paid by them.<sup>121</sup> Prior to October 1978, the Bank in consultation with the Association of Banks determined the minimum lending rate<sup>122</sup> and a maximum deposit rate. Late in 1981 however, Bank Negara changed its policy on interest rates and introduced a new interest rate regime, based on the bank-lending rate (BLR).<sup>123</sup> The introduction of the BLR reduced greatly interest rate regulation by the Central Bank.

During the mid 1980's Malaysia experienced a severe recession<sup>124</sup> Free market interest rates were suspended, and the Central Bank maintained tight control of interest rates. The country recovered from the economic depression in early 1990, and interest rate regulation other than in the priority sectors was completely freed from the administrative

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120 Mansoor, D., (Minister of Finance) *Budget Speech for 1980*, Government Publishers, Kuala Lumpur, 1979, 3-5

121 Section 37(1) b Central Bank Of Malaysia Act, 1958, (Revised 1994) *Laws Of Malaysia* , Vol. 28, Act No 519

122 There were two rates, "Prime" rate was applicable to the bank's best customers and the "Preferential" rate was applied to loans granted to federal and state governments.

123 *Money and Banking in Malaysia*, 4th Ed., Bank Negara Malaysia, Kuala Lumpur, 1994, 131

124 Sheng, A., *Restructuring in Malaysia, 1985-1988*, Working Paper, World Bank, Washington DC, 1989, 8-13



control of the Central Bank with effect from February 1991. The Central Bank, however, continues to monitor closely sectoral lending by banking institutions, and controls the ceiling on interest rates for these loans. Bumiputeras requiring loans of RM 500,000/- or less for small-scale enterprises and housing are charged a concessional interest rate. As at March 1996, interest rates on loans granted to the Bumiputera borrowers under the New Principal Guarantee Scheme of the Credit Guarantee Corporation, were fixed at 2 percentage points above the base-lending rate of the individual bank. For housing loans 1.75 percentage points above the base lending rate of the individual banks or 9% per annum, whichever was lower.<sup>125</sup>

#### 2.4.2 *Credit Controls*

Bank Negara Malaysia has the power to direct banking institutions on matters relating to the granting of loans and the extension of credit facilities, including the class of purposes for which advances may or may not be made.<sup>126</sup> The Central Bank may impose credit controls in two ways. One is to set targets or ceilings on the quantum of credit a banking institution may lend to specific groups of borrowers. The second is through moral suasion, which is an informal method of getting the required response from the financial system.<sup>127</sup>

Bank Negara issues guidelines on credit targets every year. Over the years only the directed sector has changed. If a bank is unable to lend the prescribed percentage of loans to the specified sector, then the Central Bank requires the bank to deposit the

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125 [1996] Annual Report of Bank Negara Malaysia 194-195

126 Section 37 (1) a, Central Bank Of Malaysia Act, 1958, (Revised 1994) *Laws Of Malaysia*, Vol. 28, Act No. 519

127 Lee Hock Lock, *Central Banking In Malaysia*, Butterworths, Singapore, 1987, 31-32

remaining money with it. No interest is paid. The Central Bank will then take upon itself the task of finding a bank that will lend the money to the directed sector.<sup>128</sup> The upshot is that once a credit target is fixed, banks are almost compelled to achieve the target. According to the latest lending guidelines that are available, the Central Bank has directed banks to increase loans to the Bumiputera community from 20% of the loan base to 30% of the total loan base.<sup>129</sup> Commercial banks were also required to lend a total of RM 1 billion to small-scale enterprises under the New Principal Credit Guarantee Scheme of the Credit Guarantee Corporation.<sup>130</sup> In addition it directed that 50% of the allocated quota had to be loaned to Bumiputera borrowers.<sup>131</sup> The bank also controls credit by imposing ceilings on the amount that can be loaned to specified sectors. In May 1997, there was a ceiling of 15% on share financing and 20% on property financing, which apparently was not welcomed by the banking community and the government.<sup>132</sup> Moral suasion does not appear to be effective in Malaysia because Bank Negara continues to issue lending guidelines which the banks are compelled to follow.

### 2.4.3 *Institutional Strengthening*

The Malaysian banking sector operates in an extremely competitive environment.

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128 Interview with Mr. Gopal Sundaram, Head of the Legal Department, Bank Negara Malaysia, Kuala Lumpur, on 30 May 1997.

129 [1996] Annual Report of Bank Negara Malaysia 194

130 The Credit Guarantee Corporation (CGE) was established in 1975 to provide guarantees for small and medium scale industries. The guarantee cover is extended under three schemes, namely, the New Principal Guarantee Scheme (NPGS), The Loan Fund for Hawkers and Petty Traders and the Association For Special Loan Schemes. In addition, it also provides guarantee cover under the New Entrepreneurs Fund to Bumiputera entrepreneurs through fourteen participating banks.

131 [1996] Annual Report of Bank Negara Malaysia 194

132 Interview with Mr. Gopal Sundaram, Head of the Legal Department, Bank Negara Malaysia, Kuala Lumpur, on 30 May 1997.

The banking sector is dominated by 37 commercial banks, of which fourteen are foreign owned. There are only three state owned banks. The government in its bid to promote a stronger banking sector is planning to privatise at least in part, these state-owned banks over the next four years.<sup>133</sup>

Two decades ago, the banking sector was not so advanced in its banking operations and Bank Negara was concerned at a number of trends that were developing. One problem was the deterioration in the integrity and competence of management in some commercial banks. They also lacked professionalism. Political interference in banking operations was common and lenders were often required to give loans to borrowers who were not creditworthy. Corruption was also rife to the extent that a fraud involving RM 22 Million was discovered in Bank Negara Malaysia. The situation was so grave that political interference and corruption nearly triggered the collapse of Bank Bumiputera and the government was forced to intervene and rescue the bank from its financial crisis.

Now the practice of granting politically motivated loans is very controlled. The government realised from past experience that, when banks get into financial difficulties as a result of granting these loans, it had to bail the banks out. For the government, the adverse political and economic consequences are a high price to pay.<sup>134</sup>

During the late 1980s, the government realised that the banking sector was not efficient enough to respond to the needs of modern banking techniques. It therefore introduced a range of reforms which were designed to improve a banks' liquidity and to strengthen the institutional structure. In October 1989, The Banking and Financial

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133 *Malaysia 2020*: Euromoney Publications, London, 1997, 39

134 Interview with Mr Gopal Sundaram, Head of Legal Department, Bank Negara Malaysia, at the Bank, Kuala Lumpur, on 30th May 1997

Institutions Act<sup>135</sup> (BAFIA) came into force, replacing the Banking Act 1973 and the Finance Companies Act 1969. The Act modernised and streamlined the laws governing banking and other financial institutions and provided the Central Bank with extensive powers of supervision and control over banking and financial institutions.<sup>136</sup> The Central Bank also has powers of investigation and where necessary can prosecute persons who have fraudulently induced illegal deposit taking.<sup>137</sup>

At present, the overall performance in the banking sector is satisfactory. Due to the advent of financial liberalisation, the exposure to high competition and rapid developments in technology, the banks provide a full range of banking services. Customer satisfaction is given priority and is considered important for their success.<sup>138</sup> Credit appraisal is carried out to a high standard and default loans appear to be under control. To improve customer service and bank operations further, it was suggested providing adequate training to staff, so that they could act in the best interests of the banks in the long term. Information technology is quite advanced in the banking sector, but resources must be allocated continuously to keep abreast with international standards.<sup>139</sup>

#### 2.4.4 *Islamic Banking*

An important point in the financial history of Malaysia is the establishment of Bank Islam Malaysia in 1983. The Islamic Bank provides "interest free banking" and

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135 *Laws of Malaysia*, Vol. 20, Act 372

136 *Ibid.*, Sections 69-81

137 *Ibid.*, Sections 25-28

138 During my visit to Malaysia I enquired from a number of sources about the efficiency of the banking system and the levels of services that were being offered to customers. The overall view was that customers were satisfied with the banking services that were being provided Visit to Malaysia from 30th May 1997 to 7th June 1997.

139 Interview with Mr Ng Chih Kaye, Head of Credit Department, May Bank, at the Bank

carries out its banking business in accordance with the principles of Islam.

A fundamental principle in Islam is that money cannot be lent for interest.<sup>140</sup> Therefore all lending transactions are based on a concept of buying and selling.<sup>141</sup> If a borrower requires a loan of RM 20,000 to buy a house, the bank will purchase the house and re-sell the house to the borrower for RM 22,000. The difference is the profit margin kept by the bank. All other aspects such as debt recovery are similar to conventional banking. Under Islamic banking "buying and selling" is not considered a transaction. It is considered a 'product' offered by banks to customers. At present, banks offer over forty 'different products'.

Islamic banking continues to remain a much-debated issue in Malaysia. A Malaysian legal academic has observed that trying to join religion and commercial transactions is difficult, particularly in dispute resolution. Since Islamic banking is still new, even judges are not familiar with how to solve complex disputes.<sup>142</sup>

Despite these difficulties, Islamic banking is becoming increasingly popular in Malaysia. At present over forty banks and financial institutions offer Islamic banking services. It has proved to be very effective alongside conventional banking, and several countries are interested in making it a role model in implementing their own Islamic banking system.<sup>143</sup> Malaysia's Prime Minister is also convinced that linking Islam with economic development is possible. The government has established the Malaysia Institute

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Headquarters, Kuala Lumpur, on 30th May 1997.

140 *Islamic Banking Practice*, Published by Bank Islam Berhad, 1992, 7-23 ; Haron, S., *Islamic Banking: Rules and Regulations*, Pelanduk Publishers, Kuala Lumpur, 1997, 7

141 Interview with Mr Mahayuddin Ismail, Senior General Manager-Retail Operations, Bank Islam, at Bank Islam Headquarters, Kuala Lumpur, on 30 May 1997.

142 Interview with Mrs. Badariah Sahamid, Lecturer in Banking Law, University of Malaya, at the University on 2 June 1997.

143 Lim, P., *A Role Model to Emulate*, 16 January 1997, Malaysia Business- Supplement

of Islamic Understanding (IKIM) to educate people about Islam and its role in economic activities. To Muslims, Islamic banking is presented as a practical application of their religious teachings. For non-Muslims, it is presented as an extension of choice in money-management. A politician described it more bluntly: "The only difference is whether the man behind the counter is wearing a religious hat or a bow tie."<sup>144</sup>

## 2.5 THE CENTRAL BANKS AND THEIR ROLE

A central bank plays the most influential role in a country's economic and financial development. Generally, the primary role of a central bank is the same in all countries. It acts as banker and financial advisor to the government and as the nation's monetary authority, and is responsible to the government for promoting monetary stability in the country. To improve the stability of the financial system further, a central bank will act as a banker to the banking and other financial institutions in the country.<sup>145</sup> A central bank can influence the lending policy of commercial banks and thus debt recovery.

In 1935, The Reserve Bank of India was established to secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage.<sup>146</sup> In 1950, the Central Bank of Sri Lanka was established to be responsible for the administration and regulation of the monetary and banking system of the country.<sup>147</sup>

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144 *For God and GDP*, 7th August 1993, *Economist* 57, 58

145 Cranston, R., *Principles of Banking Law*, Clarendon Press, Oxford, 1997, 117-133

146 See preamble to The Reserve Bank of India, Act No. 2 of 1934

147 Section 5, Monetary Law Act in *Legislative Enactments of Sri Lanka, (Revised 1980)*, Cap. 422; The statutory basis is vested with the Monetary Board of the Central Bank and not with the Bank itself. A significant lacuna in the Monetary Act is the absence of any specific reference to the Bank's objective of ensuring the soundness and efficiency of the financial system. The Act however, specifically provides for the establishment of two departments for economic research and bank supervision and has set out the powers and functions of these departments.

Bank Negara Malaysia was established in 1959 for the purpose of issuing currency, to keep reserves to safeguard the value of the currency, to act as a bank and financial advisor/agent to the government, to promote stability and a sound financial structure, and to influence the credit situation to the advantage of the country.<sup>148</sup>

All three banks act as the apex institution in their respective banking systems and are authorised to perform numerous functions to achieve the multiple objectives for which they were established. One of the objectives is to regulate the credit system. This may be done by managing the volume of credit available from banking institutions as well as directing the available credit from these institutions to specific sectors.

### 2.5.1 *Monetary Instruments*

It is the task of a central bank to promote the economic objectives of a country by implementing the appropriate monetary policies. To make economic objectives meaningful, values or targets must be fixed for such objectives, for example, targets on inflation and economic growth. Central banks would then attain these objectives through use of monetary instruments.<sup>149</sup>

There are two types of monetary instruments, namely, general or quantitative and selective or qualitative. General monetary instruments include the central bank lending rates, statutory reserve requirements imposed on banks, adjustments in liquidity ratios and open market operations. Selective monetary instruments direct credit to a particular sector or to a particular a type of lending. These include priority sector lending guidelines, credit ceilings imposed on banks, credit planning and other forms of direct regulation. The aim

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148 Section 4, Central Bank of Malaysia Act, 1958, (Revised 1994) *Laws of Malaysia*, Vol. 28, Act 519

149 Fernando, G., *Money, Credit and the Conduct of Monetary Policy* [1994] Economic

of these instruments is to influence the cost and availability of credit. For example if the interest rate fixed by the central bank were increased, it raises the cost of borrowing to banking institutions which in turn is borne by the borrowers. This would reduce the credit granted by banks and consequently reduce the level of economic activity. A reduction in interest rates would have the opposite outcome.

The monetary instruments used by central banks are generally standard. However, the degree of dependence on any instrument may vary in each country. The position is the same in India, Sri Lanka and Malaysia. All three central banks control the volume of available credit in the market by general as well as selective monetary instruments. The general controls used by the Reserve Bank of India include the bank rate, open market operations and variable reserve requirements.<sup>150</sup> The Central Bank of Sri Lanka and Bank Negara Malaysia also use the same instruments.<sup>151</sup> Compared to a decade ago, the use of selective instruments have considerably decreased in the three countries, but they are still being used as effective monetary instruments, particularly when lending to the priority sectors. The Reserve Bank of India and Bank Negara Malaysia continue to set lending targets for specific groups of borrowers which the commercial banks have to meet. The Central Bank of Sri Lanka used to impose credit targets in the past but after the market-orientated reforms were introduced in 1977, the practice was gradually discontinued. The Central Banks in Sri Lanka and Malaysia continue to set interest rate

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Review 18, 21

150 Tannan, M., *Tannan's Banking Law and Practice in India*, 19th Ed., India Law House, New Delhi, 1998, 62-63

151 Fernando, G., *Money, Credit and Monetary Policy*, [1994] *Economic Review* 18, 21-22; *Money and Banking in Malaysia*, 4th Ed., Bank Negara Malaysia, Kuala Lumpur, 1994, 118



ceilings on loans given to specific sectors.<sup>152</sup> In India, interest rates for loans below Rs. 200,000/= are determined by the Reserve Bank. Interest rates for loans above this amount are determined by market rates.<sup>153</sup>

## 2.6 CONCLUSION

Two decades ago, the policy of 'social control' played an important role in the Indian banking sectors and resulted in the nationalisation of fourteen large commercial banks in 1969. The effect of nationalisation on the Indian banking system was marked. A significant result was the territorial spread of banking due to the increase of branches in the rural and semi-rural areas. In June 1969, there were 8262 branches in the country and within two years of nationalisation the number increased to 12013. Out of the 3751 new branches that were opened, as many as 2480 branches (i.e. 66%) were opened in areas that did not have banks. The proportion of bank branches in rural areas increased from 22.4% as at end June 1969 to 35.6% by June 1971. Consequently, the average number of customers per bank had also reduced from 65,000 to 46,000 per office.<sup>154</sup> The overall results were very encouraging to the governments. As one leading banker commented:

“The post-nationalisation period had witnessed a complete re-orientation of India's banking from "class" banking to "mass" banking from, "asset base" lending to "production oriented" lending and from, "elite" banking to "social" banking. There has in fact been a change in the very concept, precept and outlook of banking.”<sup>155</sup>

After the banks were nationalised, they were required to take an active role in

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152 [1995] Central Bank of Sri Lanka Annual Report 127 ; [1996] Bank Negara Malaysia Annual Report 194

153 [1996] The Reserve Bank of India Annual Report 168

154 Reserve Bank of India Annual Report and Trend and Progress of Banking in India, RBI, Bombay, 71-74, and Tables 34-37

155 Ghose, B., *Bank Nationalisation : Promises and Performance* (1987) 58 Journal of the Indian Institute of Bankers 126

social reconstruction and poverty alleviation programmes. During this period a number of committees, commissions and study groups were set up to look at various aspects of the banking industry so that the policy of the governments could be implemented effectively. The important bodies include the Nayak Committee, Banking Commission, Marathe Committee, Tandon Committee, Chore Study Group and Khusro Committee.<sup>156</sup> The Narasimham Report was the latest of such studies. This report envisaged a radical change from the established policy and structure of the financial sector. The recommendations were aimed at reforming the financial sector to complement the new market orientated economic policies, which had been introduced by the new government.

The changes in government in Sri Lanka prior to 1977, suggest that its people were unsure of what they want from government policy. Every government making cuts in food subsidies was defeated at the next general election. Consequently, all governments were extremely responsive to the wishes of the electorate, and that made the implementation sound economic policy difficult. In 1994, the government that introduced historic reforms to the economic and financial systems was defeated at polls. After being governed by one party for seventeen years the people wanted a change. The new government is known to be leftist and was initially hostile towards the market-orientated policies the country was pursuing. Then the government appeared to have changed its views on market reforms.<sup>157</sup>

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156 Nayak Committee reported on adequacy of institutional credit to the small scale industries and related aspects (1993), Tandon Committee reported on framing guidelines for follow up of bank credit (1988), Marathe Committee reported on the working of the Credit Authorisation Scheme (1988), Chore study Group reviewed the system of cash credit (1988) and the Khusro Committee reported on the agricultural credit system in India (1989).

157 The Economist reported,

“Embracing market reforms is a climb down for President Kumaranatunga. In opposition she said rude things about the market. But it may be that, sooner or later, she had no option but to continue the reforms started by Junious Jayawardena in 1977. These had developed a momentum it would have been difficult to reverse. The surprise is that Mrs

Malaysia is no longer dependent on commodities, and has pursued industrialisation with speed and vigour. With a dominant manufacturing sector and a regional leader in high technology, Malaysia has been a success story in the South East Asian region. The Prime Minister, Dr Mahathir Mohamad, has been the driving force behind the last twenty years of development, and plans to ensure that the country reaches fully developed status by the year 2020.<sup>158</sup> The economic and financial reforms have involved privatisation.<sup>159</sup> The programme on privatisation involved not only the transfer of government ownership to the private sector but also the liberalisation of market forces.<sup>160</sup>

India and Sri Lanka are moving away from being planned economies with a socialist bias towards becoming market orientated economies. The Malaysian economy never had a socialist bias and continues with privatisation and export promotion policies. The banking communities welcomed the financial sector reforms which were introduced

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Kumaranatunga appears to be moving faster than the reformers of the previous government.....[h]er plans have been meekly accepted by her cabinet, which includes a number of Marxists. The United National Party, which ruled the country is sitting tight, watching with smug satisfaction the governments adoption of market policies it has advocated." *Privatisation, Yes, Peace* No, 22 July 1995, *The Economist* 66-67

158 Hamid, A., (Ed) *Malaysia's Vision 2020 : Understanding the Concept, Implications and Challenges*, Pelanduk Publications, Kuala Lumpur, 1993

159 Bhaskar, V., *Privatisation and the Developing Countries : The Issues and the Evidence*, United Nations Conference on Trade and Development, Discussion Paper No.47, UNCTAD, Geneva, 1992, 1

160 According to Mr Omar, Head of the task force on privatisation in the Prime Minister's Department in Malaysia, the objectives of privatisation include:

- a) relieving the financial and administrative burden of the government
- b) reducing the size and presence of the public sector
- c) raising efficiency and productivity and promoting competition
- d) accelerating growth
- e) meeting targets of the New Economic policy

Omar, Haji Mohd, *Privatisation Policy: Issues and Problems* in Buang, A., (Ed) *The Malaysian Economy in Transition*, National Institute of Public Administration, Kuala Lumpur, 1990, 49

in all three countries. Some authors however, have criticised financial sector reforms based on free market principles. Joseph Stiglitz, a trenchant critic of financial sector reforms has argued that financial markets are vulnerable to 'market failures' more than any other markets and therefore, government intervention in financial markets would make these markets function better.<sup>161</sup> He favours government intervention by way of directed credit and maintaining low interest rates.<sup>162</sup>

Liberalisation of the financial sector does not mean that it will function without any intervention from the government or the monetary authority. It is internationally accepted that deregulation of a financial sector is always accompanied by a rigorous set of prudential standards that have to be followed by the financial institutions. As John Crow, former Governor of the Bank of Canada said "deregulation does not mean de-supervision".<sup>163</sup> In this context the argument of Stiglitz can be accepted, but more intrusive intervention which includes directed credit and artificially maintaining low interest rates is a different matter.

The general attitude of favouring financial liberalisation must also be questioned. In the late 1970's attempted financial liberalisation in several Southern Cone countries in Latin America, like Argentina, Chile and Uruguay ended in failure. Liberalised interest rates rose to a very high level and as a result discouraged investment and led to widespread corporate insolvencies.<sup>164</sup> Non-performing loans soared<sup>165</sup> and the monetary

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161 Stiglitz, J., *The Role of the State in Financial Markets*, Proceedings of the World Bank Annual Conference on Development Economics, World Bank, Washington DC, 1994, 19, 20

162 Ibid., 39, 42-44

163 Crow, J., *Central Banks, Monetary Policy and the Financial System* [1993] RBI Bulletin 1373, 1379

164 Corbo, V., & De Melo, J., *Liberalisation With Stabilisation in the Southern Cone of Latin America : Overview and Summary* (1985) 13 World Development (Special Issue)

authorities were forced to take a series of measures to bring the crisis under control. Of course, prior to liberalisation, these countries had very unstable economic conditions which were made worse by inconsistencies in policy implementation. There may, however, be lessons to learn from the experiences of these Latin American countries.

In India, Sri Lanka and Malaysia interest rates have not been deregulated fully. Market forces have been allowed to have greater influence over the level of interest rates but government intervention continued in respect of loans given to priority sectors. Directing credit to priority sectors through various credit schemes are operated in all three countries. In addition to directing credit the monetary authorities in India and Malaysia still set credit targets, which the commercial banks must meet. This practice has now been stopped in Sri Lanka.

The motive of imposing credit targets and interest rate controls was to help finance borrowers from sectors deemed to have higher economic priority. The experiences of most countries around the world has shown that directed credit schemes and granting loans with subsidised interest rates have been a failure. These controls have increased the cost of loan funds to non-preferential borrowers, and prompted low repayment rates. Among preferential borrowers, funds have been known to be misused for non-priority purposes.<sup>166</sup> Despite these problems, there are some bankers who believe that these borrowers are a viable and bankable group.<sup>167</sup> Poor borrowers have shown that

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165 In Chile the loan defaults as a proportion of total financial assets increased from 1.4% to 19% by 1983. In Argentina, bad and doubtful debts as a ratio of total bank loans accelerated from 1.95% in 1974 to 9.13% in 1980.

166 Honohan, P., & Vittas, D., *Bank Regulation and the Network Paradigm: Policy Implications for Developing and Transition Economies*, World Bank Policy Research Paper No. 1631, World Bank, Washington DC, 1996, 11-12

167 Kabeer, N., and Murthy, K., *Compensating for Institutional Exclusion?: Lessons From*

they are able to use credit profitably, repay loans promptly and are willing to borrow at market rates of interest.<sup>168</sup> Debt repayment, particularly among women borrowers, has proved to be extremely high.<sup>169</sup> Women have demonstrated an outstanding ability to apply credit to useful projects and it is the lack of credit that has left these groups in poverty, rather than a lack of skill or motivation on their part.<sup>170</sup>

In most market economies, the present trend is to move away from direct monetary instruments.<sup>171</sup> In India, Sri Lanka and Malaysia despite their commitment to market reforms, ceilings on interest rates and credit direction are in force. Further, in India and Malaysia, the Central Banks continue to prescribe credit targets as effective forms of monetary instruments. The reason is that in these countries the majority of the population are poor, and the governments consider it a social obligation to protect the interests of the weaker sections during the process of economic change. A past Governor of the Reserve Bank of India commented,

“It is only appropriate that, where markets distort, we have to take care of those who are disadvantaged. It is gratifying that experts in mature economies are also now coming around this view that markets alone cannot always decide. Indeed, recent events seem to cast doubts on the dominant conventional wisdom “leave it to the markets and all will be well.” We have our reservations on this. So long as we do not attempt to outguess the market

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*Indian Government and Non-Government Credit Interventions For The Poor*, IDS Discussion Paper No. 356, 1996, University of Sussex, Brighton, 1996

- 168 Amarakoon Bandara, A., *Financing for SMI's in Sri Lanka*, in Junggun Oh, *Financing for Small and Medium Scale Industries in the SEACEN Countries*, SEACEN Training and Research Centre, Kuala Lumpur, 1994, 339
- 169 Walker, T., and Boulton, L., *Micro-Lending Offers Power to World's Poor*, *Financial Times* of 5 September 1995
- 170 Kuper, S., *Safe Bets and Entrepreneurs*, *Financial Times* of 21. 11. 1995; In India under the Integrated Rural Development Programme (IRDP) 40% of the beneficiaries are women, In Bangladesh 75% of the loan recipients from the Grameen Bank are women. In Indonesia, under the Bandan Kredit Kacamatan Scheme loans are mostly given to middle aged peasant women. See *Issues in Informal Finance*, World Development Report, Oxford University Press, New York, 1989, 117-120
- 171 Cranston, R., *Principles of Banking Law*, Clarendon Press, Oxford, 1997, 128

but set right the distortions, we can preserve our social goal of growth and equity”<sup>172</sup>

The disadvantaged are the people in the priority sectors. The concept of priority lending has a noble objective, but whether the objectives can be achieved without distorting the overall cost of lending in the banks must be addressed. Banks lend money that belongs to the depositors, and to take that money and lend it to specific sectors at subsidised interest rates and at the direction of the government is bound to create distortions in the cash flow of the banks. Unless the State is willing to bear the cost of the deficit, directed lending will distort the markets, presumably, this is what the Governor was suggesting when he said that distortions must be set right.

In Malaysia lending guidelines continue to be issued by Bank Negara. It was referred to as ‘rather a primitive method’ but was justified on the grounds that it was necessary because of ‘certain socio-economic considerations that cannot be ignored.’<sup>173</sup>

Research has shown that a diminishing degree of government intervention can assist financial liberalisation.<sup>174</sup> For the transition towards a market-orientated economy to be effective, the state must work to establish an environment which is conducive for

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172 Venkitaramanan, S., *Current Status of Economic Reforms in India* [1992] Reserve Bank of India Bulletin 1673, 1676

The disadvantaged are the people in the priority sectors. The concept of priority lending has a noble objective, but whether the objectives can be achieved without distorting the overall cost of lending in the banks must be addressed. Banks lend money that belongs to the depositors and to take that money and lend it to specific sectors at subsidised interest rates at the direction of the government is bound to create distortions in the cash flow of the banks. Unless the State is willing to bear the cost of the deficit, directed lending will distort the markets, presumably, this is what the Governor was suggesting when he said that distortions must be set right.

173 Interview with Mr. Gopal Sundaram, Head of Legal Department, Bank Negara Malaysia, at the Bank, Kuala Lumpur, on 30 May 1997

174 Yoon-Je Cho and Deena Khatkhate, *Lessons of Financial Liberalisation in Asia : A Comparative Study*, World Bank Discussion Paper No. 50, World Bank, Washington DC, 1989, 106

changes to be implemented.<sup>175</sup> There must be a well-planned financial infrastructure where there is provision for a flow of information. The legal and accounting systems must be able to deal with problems that may arise, and at the same time monitor events continuously. The upshot is that unless the key areas that are necessary for market operations to be effective are adequately developed, financial liberalisation would have a limited effect, and would fall short of its objective to be more efficient, competitive and effective. In countries like Japan and South Korea, the governments played an active role in the early stages of reforms when the institutional framework for a market economy was not complete.<sup>176</sup> The governments liberalised their financial systems only when they were certain the infrastructure was adequately developed to cope with the changes.<sup>177</sup>

It is not necessary to make a choice between the “market” and the “state.” Integral elements of both the state and the market could be combined to attain high economic development.<sup>178</sup> In less developed countries like India and Sri Lanka, the fundamental criteria are still in the process of being developed, and government intervention is therefore necessary. Malaysia is more advanced in the reform process, but during the initial stages the government had exerted a great deal of influence to steer the reforms in the direction it desired.

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175 *The State in a Changing World: World Development Report*, Oxford University Press, New York, 1997, 2-15

Khatkhate, D., & Dalla, I., *Regulated Deregulation of the Financial System in Korea*, World Bank Discussion Paper No. 292, World Bank, Washington DC., 1995

177 Yoon-Je Cho and Deena Khatkhate, *Lessons of Financial Liberalisation in Asia : A Comparative Study*, World Bank Discussion Paper No. 50, World Bank, Washington DC, 1989, 106

178 Gutterman, A., & Brown, R., (Eds.) *Commercial Laws of East Asia*, Sweet & Maxwell Asia, Hong Kong, 1997, 13-18; *Markets and States: Against Minimalism and Dichotomy*, Fourth Lecture in Raffaele Mattioli Lecture Series in Streeten, P., *Thinking About Development*, Cambridge University Press, New York, 1995, 200-202



Government intervention does not always have to be viewed as market destroying. State intervention could be accommodated to build a market-orientated economy, provided the degree of state intervention and the means it employs are acceptable. Eventually the State would step aside and permit the free development of markets.

## **CHAPTER THREE**

### ***CREDIT ALLOCATION AND LOAN SUPERVISION***

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- 3.1 *INTRODUCTION*
  - 3.2 *CREDIT APPRAISAL*
    - 3.2.1 *Five 'C's in Credit Appraisal*
    - 3.2.2 *Credit Appraisal In India, Sri Lanka And Malaysia*
  - 3.3 *CREDIT INFORMATION*
    - 3.3.1 *Information Provided by Banks*
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    - 3.4.2 *Usury and Money Lending Legislation in Sri Lanka*
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    - 3.4.4 *Terms of a Loan*
    - 3.4.5 *Documentation*
  - 3.5 *LOAN SUPERVISION*
  - 3.6 *INFORMAL CREDIT*
    - 3.6.1 *Role of Informal Credit and Institutional Credit*
    - 3.6.2 *Banking for the Poor*
    - 3.6.3 *New Approach to Rural Lending*
  - 3.7 *CONCLUSION*
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#### **3.1 *INTRODUCTION***

Credit plays a fundamental role in the economic development of a free market economy. For the expansion of new business activities the increased provision of credit is essential. It supplements capital, income and profits on which businesses rely for current operations and expansion. Credit must be easily accessible and promptly available to creditworthy borrowers when it is needed. Notwithstanding the creditworthiness of a borrower, a lender is always exposed to the risk of default. In the event of default, a lender must have the assurance that the principal sum lent together with interest earned can be recovered without delay. Its ability to do so is an important factor to be considered in assessing the credit risk. The traditional legal approach to debt recovery

has been through court-driven procedures, but so far it has not proved effective due to the delays experienced in the courts.<sup>1</sup> On the other hand, prudent lending would help to prevent and minimise debt recovery problems. Prudent lending primarily involves effective processing of the entire loan transaction. Proper evaluation of the credit risk, accurate documentation of the loan and security agreements, and systematic monitoring of the progress of the loans will help to minimise loan defaults.

“Prevention is better than cure”: this was an issue that was widely debated in the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security in Manila, in 1993. It was agreed that by the time a loan goes bad it is often too late, and lenders are then faced with focusing on symptoms rather than the causes of default.<sup>2</sup> When exploring the disputes between lenders and borrowers, it becomes clear that one of the causes of loan default is the lender’s failure to process the loan properly.

Lenders in developing countries find it difficult to gather information about borrowers that will assist them in assessing a borrower’s creditworthiness. The available information is often not extensive, prompt or accurate.<sup>3</sup> Lenders, particularly banks, informally exchange information about borrowers between themselves. Where a potential borrower is new to a bank, a formal credit reference from the borrower’s bank may be sought. The information provided, however, may be vague and consequently not very helpful. It is also a common practice for banks providing such references to disclaim any liability for the information they provide.<sup>4</sup>

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1 For more details - See Chapter 5, 222-236

2 Murgatroyd, P. *Legal Management Aspects of Debt Recovery : Lessons to be Drawn and Where Do We Go From Here?* Paper Presented at the Symposium on Legal Issues in Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 4

3 Ibid., 1

4 Cranston, R., *Credit, Security and Debt Recovery: Law’s Role in Reform in Asia and*

Land registries are also a useful source of information to lenders. A bank can check whether the property is encumbered and if the title to the property is clear. Another advantage is that, despite subsequent dealings, lenders can obtain priority for their security by registering it. Registration of security is also a form of public notice and lenders find it useful when assessing a potential borrower's creditworthiness.<sup>5</sup> The problem, however, is that these registries are known to be inefficient. Long delays in the registries also make way for fraudulent borrowers to provide encumbered security to banks, and as a result banks lose their priority they would otherwise have received.<sup>6</sup>

In state owned banks, autocratic attitudes and bureaucratic procedures still tend to thwart excellence in customer service.<sup>7</sup> As a result potential borrowers, particularly corporations, access private banks for their credit requirements. Even amongst small scale borrowers institutional borrowing has proved to be unpopular because of the long and cumbersome procedures that have to be followed to secure loans.<sup>8</sup> Conversely, private moneylenders provide credit easily without fuss and at short notice. Therefore, despite the exploitative nature of private money lending rural borrowers continue to use these sources for their credit needs.<sup>9</sup>

External, particularly political pressures also undermine the quality of assessing

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*the Pacific*, in Norton, J., and Andenas, M., *Emerging Financial Markets and Secured Transactions*, Kluwer Law International, London, 1997, 219, 233

<sup>5</sup> Pillai, P., *Company Law and Securities Regulation in Singapore and Malaysia*, Butterworths, Singapore 1987, 101-107; Thomas T., *Securities: Creation of Fixed and Floating Charges* [1988] 3 MLJ cxxv, cxxv-cxxvi

<sup>6</sup> Nanayakkara, R., *Commercial Banking - Views* [1994] *Economic Review* 24

<sup>7</sup> *Ibid.*, 24

<sup>8</sup> Munasinghe, C., *Banking for the Poor; Policies, Problems and Prospects*, Paper Presented at the Seminar on Banking for the Poor (Unpublished), in Colombo, on 9 October 1990, 5

<sup>9</sup> Singha, S.K. *Recovery of Loans from Farmers*, Deep and Deep Publications, New Delhi, 1992, .207; Sarap, K., *Interlinked Agrarian Markets in Rural India*, Sage

credit risks and the ability to satisfactorily supervise loan accounts and their regular recovery. Politicians often promise credit facilities to borrowers, and thereby create situations where wrong procedures have to be followed when loans are being granted.<sup>10</sup>

There is a class of persons who, because of their political connections, have succeeded in obtaining large loans from state banks even though their capacity for repayment would be doubtful to prudent lenders. It is well known that among these debtors, the default rate is high but once again political influence is used to forestall the institution of recovery proceedings. As Kailas Sarap observes:

“[I]t appears that the large farmers, because of their political connection and dominance in formal credit institutions (especially in co-operatives) have managed to postpone repayment of loans for a long period....[T]he large farmers not only have obtained a lion’s share of loans but also have a higher percentage of debt, to the extent that the piece of credit in regulated market is very low.... it is a sort of income transfer to the large farmers.”<sup>11</sup>

The obvious result of this interference is that it encourages borrowers to default because it generates a psychology of non-repayment.<sup>12</sup> It also gives the wrong impression to borrowers to think that banks are “Welfare Organisations.”<sup>13</sup> In the long term the financial interests of lending institutions are put in jeopardy.<sup>14</sup>

This chapter will discuss the key features of the law and practice of credit

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Publications, New Delhi, 1991, 63

10 Rama, A.S. “*How Can Consessional Finance Help the Poor?*” [1984- May] Yojana, 1-15; Shari, I., *Rural Development and Rural Banking in Malaysia*, in Ariffin, J., (Ed), *Poverty Amidst Plenty*, Pelanduk Publications, Kuala Lumpur, 1994, 32

11 *Transactions in Rural Credit Markets in Western Orissa, India* (1987) 15 *Journal of Peasant Studies* 83, 90

12 *Khusro Committee Report on the Agricultural Credit System in India*, Reserve Bank of India, Bombay, 1993 (Reprint) 211-215

13 Interview with Dr U., Herath, Senior Economist, Central Bank of Sri Lanka, at the Central Bank, on 4 June 1997

14 Satya Sundaran, I., *Institutional Credit in Service of Weaker Sections* in Pandey, P., and Jalal, R., (Eds.) *Rural Development in India: Issues and Policies*, Vol. 1, Anmol

allocation. Emphasis will be given to credit appraisal, lending agreements and the monitoring of the borrower. An attempt will be made to identify the problems if any. Possible solutions will be suggested.

### 3.2 CREDIT APPRAISAL

A bank “lends” money and does not give it away. The borrower is required to repay the loan with interest to the bank at a future date.<sup>15</sup> The essence of a loan lies in the obligation to repay, which may be expressed or implied. The lender, therefore, must be satisfied as to the borrower’s integrity and ability to repay the loan on the agreed terms. There would always be some risk that the borrower will default, and it is in assessing this risk that the lender needs to demonstrate both skill and judgement.<sup>16</sup>

“...it is a *sine qua non* of good lending never to afford any facility to a borrower upon whom the bank cannot rely, however strong may be the security. It is common knowledge that a good banker should know his customer and be able to judge not only his integrity but his ability to use the bank money to advantage and repay it within an acceptable period...”<sup>17</sup>

In countries like the United Kingdom, bankers use “credit scoring” as part of their credit assessment procedure.<sup>18</sup> Credit scoring, measures the statistical probability of loan default. It is based on statistical techniques that predict the future performance of

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Publications, New Delhi, 1991, 71, 74

15 A loan of money is a contract between the lender and the borrower whereby the lender pays or agrees to pay a sum of money to the borrower in consideration of a promise to repay on demand or at some future time. *Poh Kim Kang Co. and Ors v Ishak Bin Lambik and Another* [1971] 2 MLJ 25. The position is fundamentally different in Islamic banking where charging of interest (*riba*) is prohibited.

16 Some authors describe lending as an “art, rather than science” - See Rouse, C.N., *Bankers Lending Techniques*, Institute of Bankers Publications, London, 1989 but some describe it as an “art as well as a science.” See Weerasooria, W., *Banking Law and the Financial System in Australia*, 3rd Ed., Butterworths, Sydney, 1993, 553-554

17 Mather, L., *The Lending Banker*, 3rd Ed., Waterlow & Sons Ltd, London, 1966, 12

18 *Guide to Credit Scoring*, Office of Fair Trading, London, 1993

a particular group of borrowers, from the past performance of a similar group with similar characteristics. It is considered one of the most consistent, accurate and fair forms of credit assessment. For practical and economic reasons lenders in developing countries may not be able to use credit-scoring techniques. However, to assess the creditworthiness of a borrower, a lending bank would primarily look into five aspects commonly known as the 'five C's in credit assessment. They are Character, Capacity, Capital, Conditions and Collateral.<sup>19</sup>

### 3.2.1 *'Five C's in Credit Appraisal*

'Character' of a borrower plays an important role in the credit assessment process. A lending bank will look to a borrower's past record, its banking operations, integrity and reputation to establish his character. In the case of corporate borrowers close scrutiny will be made of the management team to ascertain if they possess the required management and business skills to run the enterprise effectively.

'Capacity' of a borrower requires two aspects to be assessed. First, the borrower must have legal capacity to borrow. For example, banks will not lend to minors.<sup>20</sup> In the case of partnerships unless specifically prohibited in the partnership agreement, partners have the legal capacity to borrow money on behalf of the partnership. Limited companies will have the capacity to borrow if the articles of association of a company empower its board of directors to do so.<sup>21</sup> Lending banks will

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<sup>19</sup> Grier, W., *The Asiamoney Guide to Credit Analysis in Emerging Markets*, Asia Law and Practice, Hong Kong, 1995, 1-7; It must be noted that there are more modern methods of credit analysis, but in many developing countries including India, Sri Lanka and Malaysia this traditional method continues to be used.

<sup>20</sup> Guest, A., (Ed), *Chitty on Contracts*, 27th Ed, Vol. 1, Sweet and Maxwell, London, 1994, 443

<sup>21</sup> Gower, L., *Gower's Principles of Modern Company Law*, 5th Ed, Sweet and Maxwell,

always inspect the articles to ensure that the directors can borrow and also mortgage a company's assets for the purpose of giving security. It will also check whether the Directors' powers to borrow are restrictive or not. An assessment of the 'financial capacity' of a borrower is relevant in ascertaining the repayment ability of a borrower. Individual borrowers would be asked to submit a statement of income and expenditure, and of their assets and liabilities. In the case of corporate borrowers, lenders would insist on inspecting the profit and loss accounts and the balance sheets of the business and other financial information such as cash flow statements, management accounts and final projections.<sup>22</sup>

The 'capital' base of a corporate borrower is also an indication to a lender of the borrower's financial stability. The equity of a company is an important factor to consider if the potential borrower is small and also new to the bank, or where the business is relatively new. In the first few years of a small business it will usually have little or no retained earnings, and very little external financial help. It would, therefore, have to rely on its own capital in the event of externally imposed challenges such as interest rate fluctuations, inflation and changes in market conditions.

'Collateral' is not mandatory in the securing of a loan. Lenders, however, will favour the availability of security, if, in the bank's view, there is an element of doubt as to the repayment capacity of a borrower. The amount of collateral that is taken must reflect that element of doubt. As Weerasooria writes:

"Many customers believe that the primary requirement for obtaining a loan from a bank is the availability of satisfactory security, but this is a misconception. No doubt banks are concerned with the security that a

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London, 1992, 15-17

22 Berry A. Faulkner, S., Hughes, M., and Jarvis, R., *Bank Lending: Beyond the Theory*, Chapman and Hall, London, 1993, Chapters 4 and 5



customer can offer for a loan but this ought not to be the first, or only consideration”<sup>23</sup>

‘Market conditions’ as well as social and economic conditions, affect a potential borrower’s business activities. It is quite possible that a borrower may satisfy all the other elements of credit assessment but if the potential borrower were engaged in a business that has an uncertain market, lenders would be reluctant to advance the money. For example, banks may be reluctant to lend for property development during a recession or where the property prices are reducing. A prudent lender will always closely study the prevailing conditions in a country before granting a loan.

### 3.2.2 *Credit Appraisal in India, Sri Lanka and Malaysia*

In India, Sri Lanka and Malaysia the lenders take into account the basic criteria that have already been mentioned. In each jurisdiction however, emphasis may be given to a different aspect of the credit assessment process.

In India a borrower’s creditworthiness is analysed to determine his capacity to abide by the terms and conditions of the loan agreement. In 1974 the Reserve Bank of India appointed a committee under the chairmanship of Shri P.C. Tandon to frame guidelines on bank credit.<sup>24</sup> In 1979 another committee was appointed by the Reserve Bank under the chairmanship of Shri K.B. Chore to examine the prevailing system of bank credit and the effectiveness of monitoring and follow up systems adopted by banks.<sup>25</sup> Both Committees recommended guidelines on various aspects of bank lending

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23 Weerasooria W., *Banking Law and the Financial Systems in Australia*, 3rd Ed, Butterworths, Sydney, 1993, 554

24 Tandon, P., *Report of The Study Group to Frame Guidelines for Follow-up of Bank Credit*, Reserve Bank of India, Bombay, 1988 (Reprint)

25 Chore, K., *Report of The Study Group to Review the System of Cash Credit*, Reserve Bank of India, Bombay, 1988 (Reprint)

which bankers still continue to follow.<sup>26</sup> The availability of security is fundamental when loan applications are being assessed. Lenders insist on security if a loan is to be granted. Unsecured loans are granted in special circumstances to reputed customers and if it is supported by a guarantee.<sup>27</sup>

In Sri Lanka, an attempt is made to follow British banking practices, although they may not strictly followed.<sup>28</sup> When a potential borrower is an existing customer of a bank, emphasis would be given to the banker - customer relationship. In order to determine the repayment capacity of a borrower, the type of account maintained by the customer, the facilities the bank have already granted, the manner in which the account is being operated, and the assets that has been declared to the bank are all considered. As in India, security must be furnished by a potential borrower even if he is an existing customer of the bank and irrespective of the type of loan that is required.

It is an apparent puzzle why banks in India and Sri Lanka insist on security to grant credit because in the event of default by a borrower, realising the security is a long and arduous process. The objective of taking security is to ensure that in the event of some untoward and unexpected development which jeopardises the loan, the security provided by the borrower would offset the loss.<sup>29</sup> In countries like India and Sri Lanka quick realisation of security is not effective because lenders rely on court driven procedures to realise security.

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26 Tripathi, A.R., *Bank Financing of Industries in India*, Tiwari Publications, New Delhi, 1991, 124, Appendices A and B

27 Ibid., 125

28 Interview with Mr Martin Fernando, Deputy General Manager, Credit Division, Peoples' Bank Head Quarters , at The Bank , on 14th May 1997.

29 For a very good discussion on when security should be taken by lenders see Rouse, C.N., *Bankers Lending Techniques*, Chartered Institute of Bankers Publications, 1989, 31-33

The position in Malaysia is very different to that in India and Sri Lanka. Credit assessment appears to be very thorough and all the criteria identified earlier as the five 'Cs' are looked at in detail.<sup>30</sup> All the elements are considered important but to consider a potential borrower creditworthy, it need not satisfy all five criteria. Each borrower will be assessed on an individual basis. The 'Character' of a borrower is closely looked at, not only at the time of credit assessment but also at the stage when a borrower defaults, and a bank is considering the option of rehabilitation.<sup>31</sup> Collateral is looked at as a form of insurance and is not considered essential to grant small loans. For larger loans it is a mandatory requirement under the law that security must be taken.<sup>32</sup> Banks prefer to take collateral that can be enforced by means of 'self help' remedies because it removes the cost and delay of instituting debt recovery suits.<sup>33</sup>

### 3.3 CREDIT INFORMATION

Assessing the credit rating of a potential borrower is a specialised function of a lender. Whilst there are lending guidelines, each loan application must be treated on its merits. Lenders must gather all the available information and then attempt to reach an

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30 Interview with Mr. Ng Chih Kaye, Head of Special Credits, Credit Control Division, May Bank Head Quarters, at the Bank, Kuala Lumpur, on 30 May 1997.

31 When a borrower defaults, the bank reassesses the borrower's credit rating and the criteria stated in the five 'Cs' are once again looked at. This helps a bank to decide if the bank should exit from the loan, or rehabilitate it.

32 Section 60 (1) of Banking and Financial Institutions Act, No 372, 1989, states that subject to an order made by the Bank (i.e. the Central Bank) under (2), no licensed institution shall give to any person any credit facility without security.

Section 60(2) states that; the Bank may by order published in the Gazette permit any particular licensed institution, or any class, category or description of licensed institutions, to give to any person any credit facility without security which, together with any other credit facility without earlier given to him, does not exceed an aggregate amount set out in the order. At present, the limit is RM10,000/=.

33 Chen Kah Leng, *Country Report for Malaysia*, Presented at the Symposium on Legal Issues in Debt Recovery, Credit and Security(Unpublished), Manila, 1993, 135

objective decision. Experienced bankers no doubt have developed considerable expertise in this field. Nevertheless, for assessing fairly accurately the credit rating of both big and small customers, adequate and reliable information is essential. Most of the information is provided by the customer himself, whilst some information can be obtained from external sources such as specialised agencies or other banks.<sup>34</sup>

### 3.3.1 *Information Provided by Banks*

Credit inquiries between banks may be formal or informal. Where one bank requests a credit reference from another bank, two problems arise. On the one hand, banks are inhibited in providing information because of their obligation to the customer to maintain secrecy about his financial affairs. On the other hand, banks are concerned with the possibility of being held responsible to the other party who may act upon the information provided by them.

According to the common law on bank confidentiality, (bank secrecy) the disclosure of information about customers to other banks or specialised credit agencies may be unlawful.<sup>35</sup> The much cited decision of *Tournier v National Provincial and Union Bank of India*, established that a bank is under an obligation to keep its customers affairs confidential, but the obligation imposed on banks were not absolute.

Banks LJ stated:

“At the present day I think it may be asserted with confidence that the duty is a legal one arising out of contract, and that the duty is not absolute but qualified. It is not possible to frame any exhaustive definition of the duty. The most that can be done is to classify the qualification, and to indicate its limits.....On principle I think the qualifications can be classified under four heads:

i.. where disclosure is under compulsion by law

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<sup>34</sup> Berry A., et al, *Bank Lending Beyond the Theory*, Chapman & Hall, London, 1993, 37

<sup>35</sup> Cranston, R., *Principles of Banking Law*, Clarendon Press, Oxford, 1997, Chapter 6

- ii where the interests of the bank require disclosure
- ii where there is a duty to the public to disclose
- iii where the disclosure is made by the express or implied consent of the customer.”<sup>36</sup>

According to the fourth qualification the customer can waive the duty of confidentiality, and it is quite possible that banks will make this a condition of being considered for credit.<sup>37</sup> The basis on which bankers may exchange credit information should not be left to rest on a contractual basis. If banks providing credit information can be protected by legislation the matter will be beyond legal challenge.<sup>38</sup> For example, in South Korea, the law clearly provides legal protection for institutions which have disclosed confidential information relating to financial transactions. The objective of this law is to allow financial institutions to share information to determine the creditworthiness of their customers.<sup>39</sup> By contrast, in Singapore, if a banker breaches his duty of confidentiality, he is guilty of a criminal offence.<sup>40</sup>

In India, if one bank requests a reference from another, information is generally given as a “common courtesy.” Bankers however take great care in wording the reference disclosing no more than a general position so that their duty of confidentiality

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36 [1924] 1KB 461, at 472-473

37 In the United Kingdom, The Review Committee on Banking services observed that the exceptions stated in the Tournier case had to be revised and legislated. The government did not accept these recommendations. Jack, R., *Report of the Review Committee on Banking Services : Law and Practice*, Cmnd 622, HMSO, London, 1989, Para 5.38-5.47 ; Government White Paper on *Banking Services : Law and Practice*, Cm.1026, HMSO, London, 1990, 16; Howells, G., *Data Protection, Confidentiality, Unfair Contract Terms, Consumer Protection and Credit Reference Agencies* [1995] JBL 343, 345-350

38 Campbell, D., *International Bank Secrecy*, Sweet & Maxwell, London, 1992, 626

39 Young Moo Kim and Soo Man Park, “*South Korea*” in Campbell, D., *International Bank Secrecy*, Sweet and Maxwell, London, 1992, 626

40 Section 47, Banking Act, Statutes of The Republic of Singapore, 1994 (Revised), Cap. 19; Poh Chu Chai, *Law of Banking : Banker and Customer*, Vol. 1, Longman Singapore Publishers, Singapore, 1995, 386-387

to the customer is preserved at all times.<sup>41</sup> In addition, banks safeguard themselves by adding the words “without responsibility” to the credit reference provided by them.<sup>42</sup> Naturally, such references are likely to be vague and may not be very helpful. Although bank secrecy is considered integral to a banker - customer relationship, an Indian banker has an obligation to disclose information if compelled to do so by court or by statute. For example, in the case of *Shankarlal Agarwall v State Bank of India*<sup>43</sup> a customer deposited with the bank a large sum of money in currency notes with a declaration form under the High Denomination Bank Notes (Demonetisation) Act 1978 and the bank handed the form to the Income Tax department. The court held that, although the bank had breached confidentiality, which gives rise to a claim for damages, the bank was under an obligation to provide the information under a number of statutes and the case fell within an exception. The Banking Laws Commission, while identifying the problem, took the view that national banks occupy a special position in that they are all state owned and therefore the state banks should include a statutory provision governing each bank allowing “full and frank communication of credit information between them.”<sup>44</sup> So far this recommendation has not been given effect to.

Bankers in Sri Lanka also request references from other banks particularly if the customers are new. Some banks do provide information but it is very general. A typical credit reference provided by one bank to another would only indicate whether a customer’s account is “satisfactory, ordinary or good”. The issue of breaching confidentiality therefore does not arise and, bankers hardly have occasion to be

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41 Tannan, M., *Tannan's Banking Law & Practice in India*, 19th Ed, India Law House, New Delhi, 1998, 202

42 *Report of the Banking Commission*, Government of India, New Delhi, 1972, 537

43 [1987] AIR (Cal) 29

challenged by customers.<sup>45</sup> The Banking Act provides that every director, manager, officer or employee of a licensed commercial bank should sign a declaration pledging himself to observe strict secrecy in respect of all transactions relating to the bank, its customers and the state of the accounts of any customer which may come to his knowledge in the discharge of his duty except

- (a) when required to do so by
  - (i) a court of Law
  - (ii) by the person to whom such matters relates;
- (b) in the performance of his duties; and
- (c) in order to comply with any of the provisions of the Act or any other law<sup>46</sup>

Whether sub clause (b) will be interpreted widely enough to safeguard a bank in the event confidential information is disclosed to another person is uncertain. Thus, a Sri Lankan banker will be able to disclose information only if the customer expressly gives his consent.

In Malaysia, the law of bank secrecy is governed by the Banking and Financial Institutions Act, 1989. Banks are prohibited from disclosing any information or document relating to the affairs or account of its customers.<sup>47</sup> There are, however, exceptions to this general prohibition. If information were required by a party to a bona fide commercial transaction, or for a prospective bona fide commercial transaction to which the customer is also a party to, then information may be provided to assess the creditworthiness of the customer. The information given will be general in nature and

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44 *Report of the Banking Commission, Government of India, New Delhi, 1972, 537*

45 Interview with Mr Martin Fernando, Deputy General Manager, Credit Division, Peoples' Bank Head Quarters, Colombo, at the Bank, on 14 May 1997

46 Section 77 - Banking Act, No 30 of 1988 as amended by section 32 of the Banking (Amendment) Act, No 33 of 1995

47 Section 97

will not include details of the customer's account or affairs<sup>48</sup>.

It is clear that in all three jurisdictions the banks have a duty to their customers to maintain confidentiality. The degree of confidentiality however appears to vary. In India and Sri Lanka the general prohibition is lifted only if this is required by a court of law or a statute, but in Malaysia it is relaxed in providing information of a general nature to a bona fide party to a commercial transaction. Compared with India and Sri Lanka bankers in Malaysia have more freedom to disclose information but whether the provided information would be useful due to its general nature is questionable.

### 3.3.2 *Information Provided by Credit Reference Agencies*

In countries like the United Kingdom and United States of America, commercial banks use information provided by private credit rating agencies, which specialise in collecting and disseminating credit information about individual as well as corporate borrowers. These agencies collect information from a number of sources such as court judgements, press reports and information lodged with public record offices. In India, Sri Lanka and Malaysia private credit reference agencies have not been established. Banks collect information from credit applicants themselves or from other banks. If more information were required, it would be acquired through third parties, or by reference to credit intelligence bureaux set up by the respective governments.

The Indian Banking Commission felt there was a need for outside agencies to furnish banks with information but it recognised the difficulties of establishing such agencies under prevailing Indian conditions and suggested that these agencies should be

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48 Section 99 of BAFIA, 1989



set up by legislation as separate statutory bodies.<sup>49</sup> The Saraiya Commission also recommended the establishment by legislation of specialised credit agencies, but these recommendations by both Commissions remain unimplemented<sup>50</sup>.

The Reserve Bank of India has provided a credit information service to banks since 1962. The Reserve Bank of India Act, 1934, was amended<sup>51</sup> incorporating Chapter IIIA which empowered the Reserve Bank to collect credit information from individual banks on borrowers who have obtained secured credit facilities of Rs 500,000/= and above and unsecured facilities for Rs 100,000/= or more. The Reserve Bank is authorised to collect credit information which it might consider to be relevant for the systematic regulation of credit and credit policy.<sup>52</sup> Section 45E of the Act provides protection to banks and the Reserve Bank by permitting the disclosure or publication of any credit information in accordance with the practice and usage customary among bankers or by law.

In Sri Lanka, there are no private credit reference agencies but the government has established a credit information bureau.<sup>53</sup> This statutory body was established in 1990 along the lines recommended by the Committee appointed to examine the formation of a data bank on loan defaulters and a credit information bureau.<sup>54</sup> State

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49 *Report of the Banking Commission*, Government of India, Delhi, 1972, 248-249, 538-539

50 Shroff, C. S., *India Country Report*, Presented at the Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 64

51 Act No.1 of 1962

52 Sections 45C & 45D

53 Credit Information Bureau of Sri Lanka Act, No. 18 of 1990 as amended by Credit Information Bureau Act of Sri Lanka (Amendment) Act, No. 8 of 1995.

54 *Report of the Committee on the Formation of a Data Bank on Loan Defaulters and a Credit Information Bureau*, 1987. The Central Bank of Sri Lanka has confirmed to me that this report was destroyed during the bomb explosion 1996.

banks, commercial banks and finance houses are permitted to become members of the Bureau. The Bureau has the power to request a lending institution to furnish it with any information it may require. It shall be the duty of the lending institution to furnish the Bureau with the information it requested “not withstanding anything to the contrary, in any law establishing such lending institution or other law or in any agreement entered into between such lending institutions and borrower.”<sup>55</sup> The principal functions of the Bureau are collecting credit information, developing the database on borrowers and supplying credit reports on borrowers. Members are required to provide information to the Bureau of overdue accounts that are Rs 100,000/= and above, and of regular accounts that are Rs 500,000/= and above. Since the Credit Information Bureau was established, there has been an increased interest by lending institutions to utilise the credit information service and the overall performance of the Bureau is satisfactory. In 1995 the Bureau supplied 98,282 credit reports. In 1994, it responded to 71,623 requests for credit reports as against 58,657 in 1993.<sup>56</sup>

Rating Agency Malaysia Berhad (RAM) is the only credit rating agency in Malaysia. In 1990, Bank Negara Malaysia as part of its continuing effort to develop the private debt securities market, incorporated RAM as a public limited company. The main function of RAM is to rate all issues of bonds and commercial paper and to provide information to potential investors in both the primary and secondary issues of private debt securities. RAM also provides a professional judgement of a corporation’s creditworthiness.<sup>57</sup> However, under the provisions of section 97(1) of BAFIA, 1989,

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55 Section 21 (2)

56 [1995] Annual Report of the Central Bank of Sri Lanka, 127

57 *Money and Banking in Malaysia: 1959-1994*, 35th Ed., Bank Negara Malaysia, Kuala Lumpur, 1994, 400

RAM is prohibited from obtaining information regarding individual customer accounts, and from making reference to any customer name in its published reports. Such information may be used in the form of aggregate figures, so that the banks providing the information to RAM would not contravene the provisions against disclosure in the Act.

It was mentioned earlier that in all three countries, private credit reference agencies do not exist. A question that arises is whether the establishment of such agencies would make credit appraisal more effective and efficient. If private credit reference agencies were to be established, there are a number of safeguards that must be observed to protect the interests of borrowers as well as of lenders. The rating agencies must be licensed and be accountable to the government or the central bank. The procedures followed by these agencies to report credit information must be fair as well as accurate. Guidance could be sought from the Fair Credit Reporting Act, 1970 of the United States of America, which requires credit reporting agencies to exercise their responsibilities with fairness, impartiality, and a respect for the consumer's right to privacy.<sup>58</sup> It also requires these agencies to adopt reasonable procedures "in a manner which is fair and equitable to the consumer, with regard to the confidentiality, accuracy, relevancy and proper utilisation of such information."<sup>59</sup> It is equally important that the customer about whom credit information is reported is given the opportunity to correct any errors in the report. In the United Kingdom, the Crowther Committee reporting on consumer credit also suggested the adoption of just and equitable credit reporting procedures, the debtor being given the right to obtain details of filed information and the

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58 Section 1681(a)(4) in United States Code Annotated, Title 15, West Group, St Paul, 1998

59 Section 1681(b), Ibid.

opportunity to correct any discrepancy.<sup>60</sup>

There are inherent difficulties in the effective running of private rating agencies in these countries. Collecting information is not an easy task. The public record offices, which are primary sources of information, are not up to date and in some instances information is non-existent. For example, the author visited the Registrar of Companies in Colombo and requested to see the complete record of any company that had been wound up by court in the recent past, but such a file could not be located despite a number of companies having been the subject of winding up proceedings.<sup>61</sup> Generally, the public record offices are slow in recording information and are known to be inefficient. Further, banks will not disclose information about customers to private credit reference agencies without statutory direction.

### 3.4 *LENDING AGREEMENTS*

A loan agreement must be just and equitable to lenders as well as borrowers. Bankers must feel confident that the provisions in the loan agreement will afford them adequate credit protection and give them power to exert influence over borrowers, or control over a loan if necessary. For example, if the bank were in an unsecured position it would insist on including restrictive covenants into the loan agreement to protect itself. If a bank were aware that a corporate borrower has had a doubtful past record or there are material doubts related to the loan, it may want the right to control the loan tightly. On the other hand, a borrower company may consider this an unwanted intrusion into the management's freedom to run the company. Nevertheless, it is the

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<sup>60</sup> Lord Crowther, *Report of the Committee on Consumer Credit*, Cmnd. 4596, HMSO, London, 1971, 374-376; See now section 159 of the Consumer Credit Act, 1974

<sup>61</sup> Visit to the Registrar of Companies, Colombo, on 13 May 1997

price to pay to obtain a loan.

Borrowers must not feel vulnerable because of their inability to stop lenders from doing what they want. In developed systems of law, there are a number of ways in which transactions that are unreasonable may be nullified.<sup>62</sup> Judges have ruled that if a contract is unconscionable, or that it has been entered into under duress or undue influence, such a contract is void.<sup>63</sup> A security taken by a bank may become unenforceable if it can be shown that there was an inequality of bargaining power between the bank and the borrower, or that independent advice had not been available to the borrower before the security documents were signed, or that the bank officer had acted in an unconscionable manner when dealing with the security transaction, or that all the circumstances to the transaction had not been fair, just and equitable.<sup>64</sup> In various countries legislation has also been enacted to protect contracting parties. According to the provisions of the United Kingdom Unfair Contracts Act, 1977, even though the parties enter into certain contracts which appear absolutely proper and enforceable, a court nevertheless, has jurisdiction to treat it as unenforceable, on the ground that they were unreasonable. Schedule 2 to the Act sets out a number of criteria which a court must take into account when enforcing certain contracts between parties. One such criterion is the respective bargaining power of the parties. The Council of the European Communities has issued a Council Directive on unfair terms in consumer contracts.<sup>65</sup> A notable provision in the directive is that the consumer should be given an opportunity to

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<sup>62</sup> Cranston, R., *Principles of Banking Law*, Clarendon Press, Oxford, 1997, 227-237

<sup>63</sup> *Barclays Bank v O'Brien* [1994] 1 AC 180 (HL); *Shotter v Wespec Banking Group* [1988] 2 NZLR 316; *Geffen v Goodman Estate* (1991) 81 DLR (4th) 211 (SCC)

<sup>64</sup> *Barclays Bank v O'Brien* [1994] 1 AC 180 (HL); *National Westminster Bank v Morgan* [1985] 1 AC 686; *Cornish v Midland Bank Plc* [1985] 3 All ER 513

<sup>65</sup> Council Directive 93/13/EEC in Official Journal of the European Community No. L

examine all the terms of the contract and, in the event any terms proves ambiguous the construction most favourable to the consumer should prevail.

In India and Malaysia, loan agreements are governed by English legal principles. Judges will not enforce loan agreements that are harsh and unconscionable.<sup>66</sup> In Sri Lanka, Roman Dutch Law recognises the doctrine of “*laesio enormis*”. A court cannot enforce a contract between parties if it were grossly inequitable, even if *prima facie* there is no duress, fraud or other nullifying circumstances.<sup>67</sup> Not only in countries that have developed systems of law, countries that have a *laissez-faire* system of law will neither recognise nor enforce an agreement that would be inequitable.<sup>68</sup> However, in these countries there is no legislation striking at unfair contract terms, except the usury laws.

#### 3.4.1 *Usury and Money Lending Legislation in India*

In India the Usurious Loans Act 1918 gives power to a court to prevent enforcing a contract that is unconscionable and usurious. If a court has reason to believe that the amount payable on a loan transaction is high or unfair due to a high interest rate that is being charged, the Act empowers the court to re-open the transaction and relieve the debtor of all liability in respect of any excessive interest.<sup>69</sup> The expression

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95/29 of 21-4-1993.

<sup>66</sup> Abichandani, R., (Ed) Pollock and Mulla on *Indian Contract and Specific Relief Acts* 11th Ed., Vol. 1, N.M. Tripathi Pvt. Ltd., Bombay, 1994, 234-236; Dato Visu Sinnadurai, *The Law of Contract in Malaysia and Singapore*, 2nd Ed, Butterworths, Singapore, 1987, 215-217

<sup>67</sup> The doctrine of *Laesio Enormis* has been abolished by statute in many of the provinces of South Africa, the other major Roman Dutch jurisdiction in the world.

<sup>68</sup> Farnsworth E.A., *An Introduction to the Legal System of the United States*, 3rd Ed., Oceana Publications, New York, 1996, 124

<sup>69</sup> Section 3(1)

‘excessive’ has been interpreted to mean, in excess of that which court deems to be reasonable having regard to the risk incurred as it appeared, or must be deemed to have appeared to the creditor at the date of the loan.<sup>70</sup>

In 1984, the Banking Regulation Act, 1949 was amended<sup>71</sup> by inserting section 21A which provided that, notwithstanding the provisions of the Usurious Loans Act and comparable state legislation, a court was prohibited from re-opening transactions between a bank and its debtor on the ground that the interest charged was excessive. This amendment has caused much controversy in the High Courts, and its scope and application has been interpreted differently, giving borrowers a useful defence in such cases.<sup>72</sup> Money lending legislation enacted at state level provides for the registration of moneylenders, maintenance of accounts in a particular form, exemption to specific lenders or types of transactions etc. In practice, moneylenders’ legislation is not a problem to banks because most of the laws are confined to transactions involving small amounts and does not apply to banks.<sup>73</sup>

#### 3.4.2 *Usury and Money Lending Legislation In Sri Lanka*

Parties to a loan agreement are free to fix the rate of interest, but there are some controls on particular types of money lending transactions. The Money Lending Ordinance<sup>74</sup> allows a court to re-open a money lending transaction, if the interest rate is such that the amount payable is excessive, or if the transaction is harsh and

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<sup>70</sup> Section 3(2)a; See the explanatory notes and case examples in Chitale, D., and Appu Rao, S., *The A.I.R. Manual*, Vol. 21, All India Reporter, Nagpur, 1978, 514-516

<sup>71</sup> Banking Law (Amendment) Act of 1983

<sup>72</sup> Shroff, C., *India Country Report*, Presented at the Symposium on Debt Recovery, Credit and Security, (Unpublished) 1993, Manila, 23-24

<sup>73</sup> *Krishna Reddy v Canara Bank, Bangalore* [1985] AIR (Karnataka) 228

unconscionable, substantially unfair or fraudulent. In exercising this power “the court shall observe the rule that no interest shall at any one time be recoverable to an amount in excess of the sum then due as principal.”<sup>75</sup> The effect of this rule is that if the interest exceeds the capital a creditor cannot claim the interest. In *Fernando v Sillappen*<sup>76</sup> the Supreme Court held that interest claimed up to the date of filing the action cannot exceed the principal. However, at any one time the creditor is entitled to recover a sum equal to the principal as interest.<sup>77</sup> As in India, the Money Lending Ordinance does not apply to statutory banks or to other duly incorporated banks or banking companies.<sup>78</sup>

A question that must be raised is whether this peculiar rule should continue to be in force? If a debtor deliberately avoids repaying a debt there will come a stage where the quantum of accumulated interest exceeds the value of the capital. At this point, the Money Lending Ordinance protects the debtor’s interests which is grossly unreasonable. The effect of this law is that it allows a debtor to derive a substantial benefit from his own delay, possibly from his own fraudulent intentions. This rule will also discourage lenders from giving loans to industrial borrowers for development projects. Usually project loans are given for a very long period and invariably the amount payable by way of interest will be greater than the capital. This may be the reason for exempting the application of the Money Lending Ordinance to statutes like the State Mortgage and Investment Bank Law<sup>79</sup> and the National Development Bank of

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74 Section 2(1), *Legislative Enactments of Sri Lanka (Revised) 1980*, Chapter 90

75 Section 5

76 (1918) 5 CWR 301

77 Pereira, J., *The Laws of Ceylon* Vol. 2, Government Printer, Colombo 1904, 546

78 Section 7 (d) & (e)

79 Section 67, *Legislative Enactments of Sri Lanka (Revised), 1980*, Cap. 306



Sri Lanka.<sup>80</sup>

The Wimalaratne Committee reporting on the law and practice on debt recovery, also observed that the Money Lending Ordinance and the Debt Conciliation Ordinance were both enacted at a time when the banking and financial system of Sri Lanka was not developed, and that the rationale for their applicability no longer exists in relation to approved credit agencies.<sup>81</sup> The only justification for this rule to continue in force is, as an inducement to the lender not to delay too long to institute recovery proceedings when default occurs, but whether this reason is a strong enough ground to allow this provision to be in force is doubtful. It is submitted that it is no longer appropriate as a general rule and the law must accordingly be amended.

### 3.4.3 *Money Lending Legislation In Malaysia*

The Money Lenders Act<sup>82</sup> has the same statutory provisions as its counterparts in India and Sri Lanka. A money lending transaction is considered harsh and unconscionable if the interest rate charged by the lender is “excessive”. Both in India and Sri Lanka the expression “excessive” means in excess of that which a court deems to be reasonable<sup>83</sup> but in Malaysia it is defined in the statute itself. The Money Lenders Act prescribes a maximum of 12% for a secured loan and 18% for an unsecured loan and if the loan transaction exceeds these rates it is considered excessive.<sup>84</sup> The Act

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80 Section 65, *Legislative Enactments of Sri Lanka (Revised)*, 1980, Cap. 308

81 *Report of the Committee on the Law and Practice Relating to Debt Recovery*, Under the Chairmanship of Late Justice Wimalaratne, Vishva Lekha, Ratmalana, 1985, 14

82 Act No. 400 of 1951

83 India - Section 3(2)a of the Usurious Loans Act, 1918; Sri Lanka - Section 4 of the Money Lending Ordinance

84 Section 22

prohibits the charging of compound interest and default interest.<sup>85</sup>

The Act also protects the borrower's interests by requiring money lenders to be licensed.<sup>86</sup> It also requires a money lender to provide the borrower with a written memorandum setting out the main terms and conditions of the loan agreement before granting the money.<sup>87</sup> As in India and Sri Lanka, the Act does not apply to banks, merchant banks, finance companies and institutions that have obtained specific exemptions from the Minister of Finance.<sup>88</sup>

Compared with India and Sri Lanka, an aspect of lending that is peculiar to Malaysia is Islamic banking that operates parallel with conventional banking. Lending is allowed in Islam but it must be without interest<sup>89</sup> (riba) because charging of interest is forbidden under Islamic law. Therefore, if a lending contract is governed by Islamic law issues relating to interest will not arise and no legal controls will be necessary to protect borrowers from unconscionable contracts due to excessive interest rates. Usury law is thus not known to Islamic banking law.

#### 3.4.4 *Terms of a Loan*

When a loan agreement is being drafted, the covenants must be designed to achieve at least three objectives for the lenders. First, in addition to repaying the loan, a bank must commit the borrower to obligations such as providing financial information regularly to the bank, undertake not to dispose of its assets, or change its business

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85 Sections 22(4) & (5)

86 Section 15

87 Section 19

88 Section 19

89 Haran, S., *Islamic Banking : Rules & Regulations*, Pelanduk Publications, Selangor, 1997, 7

activities. Second, the covenants must put the lender in a strong position in the event of default. The bank must have the right to terminate the agreement, and where relevant, be released from providing further loans that were agreed. Third, they must enable lenders to recover the money when default occurs without difficulty, preferably without recourse to court. From a borrower's stand point, agreeing to these covenants may be regarded as the price he has to pay to secure a loan at a reasonable interest rate. The borrower's concern, however, will be to minimise the intrusiveness of a bank into the freedom of how it conducts its affairs.

A bank will want the covenants to provide adequate credit protection and to give it influence over the borrower and control over the loan. When a loan is not supported with security, or bank guarantees are not available, strict covenants in the loan agreement are vital to maintain credit protection for the bank. Similarly, if the borrower's past record has been questionable or the bank is of the view that a tight control must be kept over the loan, very restrictive covenants will be included in the agreement. In practice however, banks consider the primary role of covenants as being to restrict management discretion and control the loan.<sup>90</sup>

Covenants serve as a useful tool to provide an early warning signal of problems when borrowers are in financial difficulties.<sup>91</sup> In such an event covenants can be the basis on which negotiations may be initiated with the borrower. Once negotiations are opened, covenants provide lenders with flexibility and allow banks time to negotiate a satisfactory deal. A bank does not rely on covenants alone to get repaid. All they will do is give the

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<sup>90</sup> Day, J., and Taylor, P., *Bankers' Perspectives on the Role of Covenants in Debt Contracts* (1996) 11 JIBL 203

<sup>91</sup> Day, J., and Taylor, P., *Loan Documentation in the Market of U.K. Corporate Debt: Current Practice and Future Prospects* (1997) 12 JIBL 7

bank a negotiating position that it would otherwise not have, and provide leverage and flexibility in the negotiations. In summary, covenants provide the means to apply pressure and to seek repayment or provide assistance by way of advice and support to the borrower through difficult times. It is important to note however that, covenants alone cannot automatically provide early warning signals. Careful monitoring and constant contact with the borrower is essential if covenants are to be fully effective.

#### 3.4.5 *Documentation*

It is fundamentally important that loan agreements are carefully drafted and documentation for security properly prepared.<sup>92</sup> Loan documentation becomes most important at the time when steps are being taken to recover overdue debts, particularly if legal action has to be initiated. In such an event, the loan documents must be capable of being admitted as evidence in a court of law. When a borrower defaults and disputes arise, the defects at the outset of a loan are often used by borrowers to defend legal actions filed against them by the banks. Loopholes, and defects in documentation offer strong defences to borrowers and consideration of these at trials are often very time consuming, resulting in long delays in litigation. If the documents were defective, the very purpose of obtaining documents at the stage of granting the loan would be defeated. It is therefore essential that due care is taken when loan documents are prepared, and the required procedure is followed.

If documentation is to be in order there are a number of aspects that must be checked carefully, ideally, by a lawyer. Diligent enquiries must be made by the lender to

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<sup>92</sup> For a detailed discussion on layout and content of a loan agreement, debenture and guarantee, See Rabinowitz, G., and Beattie-Jones, V., *Loan and Security Documents*, Jordon Publishing Ltd., Bristol, 1996

determine if a corporate borrower is validly incorporated, that it can legally own property, carry on its business and enter into contractual obligations.<sup>93</sup> Where secured transactions are concerned, lenders must refer to the relative registries, and ascertain that the security is free of prior encumbrances, and there are no liens or claims filed or registered against the borrower or the property. In countries like India, the problems relating to the investigation of title are complex,<sup>94</sup> nevertheless, it must be carried out. A classic example is the case of *Commonwealth Bank of Australia v Friedrich*<sup>95</sup> where senior bank staff was deceived into giving A\$100 million against non-existent and fictitious securities. The case has been highlighted as the tragicomedy of bank lending.<sup>96</sup> John Frederic, a conman, secured loans from several banks on the security of containers supposed to contain safety equipment valued at A\$250,000, which were in reality empty. Tadgell J observed:

"The evidence indicates that at no stage, either before granting the facilities or until the company's collapse, did the State Bank of Victoria *make any useful investigations to ascertain the existence of value* of the containerised safety equipment or of the debtors over which it assumed it held security. The fact was that these securities were practically worthless having regard to the enormous debt that they were intended to secure."<sup>97</sup>(emphasis added)

Attention must also be given to the loan agreement. In particular, the interest rate provisions of a loan agreement must be carefully analysed to determine whether they comply with the law and can be enforced. Lenders must also ensure that, the loan agreement does not contain any provision that may be construed by a court as a penalty. Usually, such a provision will take the form of an additional charge by way of an increase

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93 Estey, W. M., *Legal Opinions in Commercial Transactions*, Butterworths, Toronto, 1990, 147

94 Narula, R. K., *Bank Documentation and Execution*, UDH Publishers, Delhi, 1982, 219

95 (1991) 5 ACSR 115

96 Weerasooria, W., *Banking Law and the Financial System in Australia*, 3rd Ed, 1993, Butterworths, Sydney, 568

97 (1991) 5 ACSR 115, 165

in the interest rate in the event of default. Where a floating or fixed charge is being obtained the debenture creating the charge must be valid, binding and legally enforceable in respect of the property covered by the charge. If a bank takes a guarantee, its enforceability must be considered.<sup>98</sup> The liability of a guarantor will exist when there is default by the principal debtor, but sometimes guarantees will have a clause included requiring a specific act like sending a letter of demand before any suit can be instituted. In such a situation, unless the specific act is carried out, the guarantee will not be enforceable against the guarantor.<sup>99</sup> Another aspect to consider is whether the guarantee could be regarded as a fraudulent conveyance or as a preference.

A common complaint from lawyers in South Asia is that they are not involved in finalising loan documentation and as a result lawyers find the terms of a contract difficult to enforce.<sup>100</sup> Bank officials undertake this task by using standard forms which are often subject to dispute. Sometimes, loan documents are poorly drafted because bankers do not have the required skill and training to draft such documents.<sup>101</sup> The documents are often completed under pressure, and as a result are fraught with mistakes.<sup>102</sup> Some common

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98 Nariman Bt Mohd. Sulaiman., *Principal - Debtor Clause and the Letter of Demand* [1995] MCLJ clix

99 Section 81 of the Malaysian Contracts Act, 1950, *Mok Hin Wah & Ors v UMBC* [1987] 2 MLJ 610

100 Cranston, R., *Credit, Security and Debt Recovery: Law's Role in Reform in Asia and the Pacific* in Norton, J., and Andenas, M., *Emerging Financial Markets and Secured Transactions*, Kluwer Law International, London, 219, 237

101 This appears to be a common problem in most countries. Apparently in Australia, it is not unusual for bankers to use the wrong security form, pay insufficient attention to completion of details such as signing, dating and witnessing or fail to attend to prompt registration of security. See Weaver, P. M., *Banking and Lending Practice*, 3rd Ed, Serendip Publications, Sydney, 1994, 236

102 Ashim Barande, *Documents for Bank Advances*, Business Book Publishing House, Bombay, 1991, 249-253. The appendix to this book lists 26 mistakes committed in bank documentation, in India; *Memorandum on Debt Recovery*, Presented by the Federation of Chambers of Commerce and Industry of Sri Lanka, (Unpublished) 1991, 8-9

mistakes in bank documentation include, documents signed in blank, for example a hypothecation with a blank schedule of goods charged, documents signed after stamping, partners or directors executing documents on different dates or directors of a company witnessing the common seal of a company on different dates, and documents written in English and signed in the vernacular. Sometimes, letters of guarantees are signed in blank or are signed at the place of the guarantors, which allows a defendant to raise claims of undue influence or unconscionableness. These defences can also be raised when a spouse is required to execute a guarantee without an independent person being present.

In India and Sri Lanka bankers generally complete loan documentation.<sup>103</sup> Standard printed forms are frequently used, although the type of form may vary according to the type of facility or bank. National banks follow a similar format and foreign banks have their own documentation in accordance with international practices. Similarly in Malaysia, lawyers have no role in preparing loan documents except to check whether the security offered by a borrower is legally enforceable.<sup>104</sup> Lawyers become involved in loan documentation only where housing loans are granted and the land is offered as security, or where loans are supported by land as security, or a pledge of shares or where a debenture is given by a borrower.

There is no common solution to the problems related to loan documentation. It is a matter that needs to be addressed by individual banks taking into account the availability of in house lawyers, trained banking officials, and the operational procedures within

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103 Sardesai, V., *Essentials of Documentation*, (1995) 66 *Journal of the Indian Institute of Bankers* 99 ; Interview with Mr. P. Gunasekera, Chief Legal Officer, Peoples' Bank Head Quarters, at the Bank, on 14 May 1997 ; Shroff, C., *Country Report for India*, Presented at the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 20

104 Chen Kah Leng, *Country Report for Malaysia*, Presented at the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 23-24

banks. Staff training and making available manuals of instructions may be of some assistance but these measures alone will not be adequate to eliminate the problems associated with documentation. Increased use of lawyers in the preparation of loan documentation would assist in reducing the amount of legal disputes that arise out of mistakes in documents that are badly drafted. No doubt, this would involve an additional expense to banks but it is likely to yield far more effective results in the long term, compared to the high litigation costs that may have to be borne if the matter is referred to a court of law.

Another aspect that must be looked at is the various disincentives in the law that prevents proper documentation. The problem revolves around minimising high stamp duty and registration fees when loan agreements are signed and security is taken. In India, an English mortgage<sup>105</sup> is subject to heavy stamp duty. The advantage to a bank of taking this type of mortgage is that in the event of default, the security can be enforced by way of extra-judicial sale<sup>106</sup> but banks tend to ignore this advantage because of the high cost involved in stamp duty. Bank's, prefer to take mortgages by way of a deposit of title deeds simply because they are not subject to stamp duty, even though to realise the security a court order is required.<sup>107</sup> It is doubtful whether high stamp duty needs to deter banks from taking proper security. Inevitably, these charges will be passed on to the borrower and if it can be spread over the loan period the burden will not be prohibitive. The Supreme Court of India has also ruled that such costs and charges are allowable deductions for the

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105 Section 58 of the Transfer of Property Act, 1882 defines a mortgage. It is a mortgage where the mortgagor transfers the mortgaged property absolutely to the mortgagee subject to the condition that it will be re-transferred to him when the mortgage debt is settled. See Goyle, L., *Transfer of Property Act*, Eastern Law House, Calcutta, 1991, 206

106 Section 69, Transfer of Property Act, 1882

107 Section 67, Transfer of Property Act, 1882, See also Biswas, A. R., *Rashbehary Ghose, On Law of Mortgage*, 6th Ed, Calcutta, Kamal Law House, 1988, 293



purpose of income tax.<sup>108</sup> If the tax deduction is taken into account, the argument that taking legal mortgages are expensive is considerably weakened.

This problem is seen in Malaysia as well. Loan agreements as well as security instruments are subject to a 0.05% stamp duty on the entire value of the loan. Invariably, borrowers have to bear this cost. If the bank considers the borrower to be a good customer, loans are granted without entering into a proper loan agreement or taking security. Instead of a loan agreement a promissory note may be taken or banks may rely on their offer letter and the signed acceptance by the borrower as proof of the loan.<sup>109</sup>

### 3.5 LOAN SUPERVISION

The objective of supervising a loan is to verify, first, whether the basis on which the lending decision was taken continues to hold good,<sup>110</sup> and second, whether the loan funds are being properly utilised for the purpose they were granted.<sup>111</sup> To satisfy these objectives banks must see whether the character of the borrower, its capacity to repay the loan, capital contribution, prevailing market conditions and the value of the collateral that was taken continues to remain the same.

A bank may monitor a borrower in one or two ways. First, a bank can follow up the financial stability of a borrower by periodically scrutinising the operations of the accounts, verifying the value of security and examining the stock statements. Second, bank officials can personally visit the borrower periodically to determine the progress of

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108 *The India Cements Ltd., v The Commissioner of Income Tax* [1966] A I R (SC) 1053

109 Cheng Kah Leng, *Country Report for Malaysia*, Presented at the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 28-29

110 See the Recommendations of the Tandon Committee reproduced in *Tannan's Banking Law and Practice in India*, 19th Ed, India Law House, New Delhi, 1998, 1034

111 *Report of the Banking Commission*, Government of India, Delhi, 1972, 50

the borrower company's business activities and where necessary giving advice to resolve any problems. A bank official may sometimes be appointed to the board of directors of a company that has been granted a loan. Banks however eschew this practice, either because they do not have adequate officials who are capable of undertaking the task, or because they may be held legally responsible in the event of a borrower becoming insolvent.<sup>112</sup> It is clear that effective credit monitoring involves looking into various operations of the company including the operation of the loan, and checking whether the company is properly managed and the environment in which the company is carrying out its business is satisfactory. In summary, operations, management and environment are the key features of credit monitoring.

In India, a genuine attempt has been made to evolve an effective credit monitoring system throughout banks. The first step in this direction was taken in 1965 when the Credit Authorisation Scheme was introduced. Thereafter, several credit monitoring schemes were implemented following the recommendations of various study groups and working committees. The Tandon Committee, Chore Committee, Marathe Committee and Pendharkar Working Group have all made various recommendations. The greater part of these recommendations were on new lending norms, effective follow up systems and management information services (MIS) for monitoring of loans and the parameters for financing sick units.<sup>113</sup>

The Pendharkar Working Group suggested that a uniform and comprehensive information system should be started in all the banks, and as a direct result the "Health

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112 Wood, P., *Lender Liability Under English Law*, in Cranston, R., (Ed) *Banks, Liability and Risk*, 2nd Ed, Lloyds of London, 1995, 86-89; Douglas-Hamilton, M., *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor* (1975) 31 *Business Lawyer* 343

113 Dr Kaveri, V., and Karunasagar, S., *Health Code System: A Critique* (1992) 21 *Prajanan*

Code System" (HCS) was introduced in 1985. The salient feature of the Health Code System is that it classifies all bank loans into one of the eight groups of the Health Code.<sup>114</sup>

The Health Code System is supposed to be used by banks to follow up and monitor borrowers but the Code has a number of limitations. Most of the deficiencies arise from inadequate definitions in the Code which makes classification of loans difficult. The Code, however, can be used as a useful tool to quantify credit risk and to facilitate appropriate follow up action. It is by no means an end in itself but a means to an end.

Another programme that concentrates on credit monitoring is the "Service Area Approach" introduced in 1989. This programme concentrates on rural lending and one of its primary objectives is to ensure that bank credit is properly utilised by rural borrowers.<sup>115</sup> Proper supervision of the end use of loan funds is the main task of the scheme. The credit monitoring schemes which are in progress within the banking system are regularly monitored by the Reserve Bank of India.<sup>116</sup>

Rigorous monitoring is almost non-existent in Sri Lanka. No serious attempt has been made to address the matter either. The general practice in the State Banks are that, once a loan is granted the files are "closed" until default occurs and the banks attention is drawn to the matter.<sup>117</sup> It was said that the lack of supervision is due to the banks being understaffed, and consequently, they are unable to allocate competent staff to carry out

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- 114 Health Code No. 1 - Satisfactory, No. 2 - Irregular, No. 3 - Sick - Viable/Under Nursing, No. 4 - Sick - Non Viable/Sticky, No. 5 - Advances Recalled, No. 6 - Suit-filed accounts, No. 7 - Deceased Debts, No. 8 - Bad and Doubtful Debts.
- 115 Ojah, P., *Service Area Approach* [1989] RBI Bulletin 137; Malhotra, R., *Service Area Approach*, [1990] RBI Bulletin 715
- 116 Examples are the Credit Management Arrangement (CMA), Quarterly action plan meetings, Periodical inspections and direct contact with the senior executives of the banks.
- 117 Interview with Mr. P. Gunasekera, Chief Legal Officer, Peoples' Bank Head Quarters, at

regular monitoring. It is indeed an inadequate reason and definitely a short sighted one, particularly when loan defaults are a significant threat to the financial stability of the banks. There also appears to be a problem with the attitude towards default. For example, the Federation of Chambers of Commerce and Industry of Sri Lanka observed that

"[C]aution must be made that overdoing such monitoring can sometimes be a *harassment* or an interference to the borrower in carrying out his project. Therefore, though monitoring is necessary it should be carried out with *utmost caution and prior agreement* so that it would not affect the progress of the project." (emphasis added)<sup>118</sup>

The Federation also suggests that, at the time of granting the loan the guidelines relevant to monitoring must be made part of the loan instrument, and that such provisions must be made compulsory by law. The underlying presumption of these comments appears to be that the lender must at all times be concerned of the borrower's interests. The fact that appears to be overlooked is that the borrower has a binding obligation to repay the loan he took from the lender. If a lender monitors the loan rigorously to ensure repayment, it cannot be construed as a "*harassment*". If this kind of attitude is allowed to prevail without challenge a debt conscious culture which is already lacking in Sri Lanka will never be nurtured.

In Malaysia banks do monitor loans and it is usually carried out by the credit departments.<sup>119</sup> Staff shortages to carry out loan supervision, particularly in rural areas are a problem to lenders, but are not a cause for concern yet.<sup>120</sup> Perhaps the extensive credit appraisal that is carried out prior to lending may have had the desired result, because loan

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the Bank, on 14 May 1997

118 The Federation of Chamber of Commerce and Industry of Sri Lanka, *Memorandum on Debt Recovery Laws in Sri Lanka*, (Unpublished) 1990, 11

119 Chen Kah Leng, *Country Report for Malaysia*, Presented at the Regional Symposium on Legal Issues on Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 34

120 Baharuddin, A., Cheema, S., and Yaacob, H., (Eds.) *Credit and Rural Development*, Universiti Sains Malaya, Kuala Lumpur, 1978, 22

defaults are relatively few,<sup>121</sup> thus the need for rigorous monitoring of loans has not arisen.

Monitoring of a loan is carried out as a matter of routine banking functions.

Regular systematic monitoring of the progress of the loan will assist in minimising loan defaults. When a borrower is in financial difficulty, regular monitoring will indicate the problem to the bank. Action can then be taken as a matter of urgency to deal with the matter. The underlying principle is that loan repayments must be taken seriously by the lender if they are to be taken seriously by the borrower. As one banker in the United Kingdom commenting on the purpose of debt covenants observed:

"Covenants in themselves don't allow a bank to lend money and then put the file away for five years - that bank still needs to keep in contact with the customer at all times."<sup>122</sup>

### 3.6 *INFORMAL CREDIT*

"It is difficult to give a clear-cut definition of the informal sector because of its heterogeneity. The term covers the activities of a great number of intermediaries such as the professional and non-professional moneylender, pawnshops, merchants and petty traders, landlords, shopkeepers, indigenous bankers and finance corporations; it also contains self help groups like guilds and other professional, recreational and religious organisations, burial associations and a great number of rotating and non-rotating savings and credit associations; finally it covers private borrowing and lending arrangements between friends, neighbours and relatives. The essential characteristics of the informal market are its fragmentation and specialisation, its localised and small scale operations which are beyond the reaches of official regulation and control by the central bank. Most of its transactions are not recorded in official statistics."<sup>123</sup>

There is a common belief that credit from the informal sector is inherently expensive, due to the applicable high interest rates, and that such credit is generally

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121 Interview with Mr. Ng Chih Kaye, Head of Special Credits, Credit Control Division, May Bank Head Quarters, at the Bank, Kuala Lumpur, on 30 May 1997

122 Jay, J., and Taylor, P., *Bankers' Perspectives on the Role of Covenants in Debt Contracts* (1996) 11 JIBL 201

123 Bouman, F., *Small, Short and Unsecured: Informal Rural Finance in India*, Oxford University Press, Delhi, 1989, 6

used for unproductive purposes. On the other hand, the cost of credit from public institutions is cheap and used for productive purposes. But experience has shown that in less developed countries low interest rates alone offered by credit institutions are inadequate to draw the rural borrowers away from their traditional sources of credit, the moneylenders, and borrow instead from banking institutions.<sup>124</sup> In India credit institutions provide only 10% of the total rural credit despite considerable investment and expansion of these institutions.<sup>125</sup> In Sri Lanka the non institutional sector provides over 70% of the rural credit.<sup>126</sup> The position is similar in Malaysia.<sup>127</sup> Despite a number of rural credit programmes in force the small borrowers still borrow from money lenders, The obvious question that arises is why the rural borrowers go to private moneylenders if the interest rates charged are exorbitant?

### 3.6.1 *Role of Informal Credit and Institutional Credit*

Credit must be easily available. In most of the credit programmes designed to provide finance to the poor, there are a number of criteria a borrower has to satisfy to be able to apply for a loan. For example, a Sri Lankan co-operative bank will consider a loan application from a customer only if;

- a) the applicant has been a member of the local Co-operative Society for at least two years

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124 *World Development Report*, Oxford University Press, New York, 1989, 112-113; Bouman, F., and Houtman, R., "Pawn Banking as an Instrument of Rural Banking in the Third World" (1988) 37 *Economic Development and Cultural Change* 69-89

125 Singha, S.K., *Recovery of Loans from Farmers: Repaying Capacity and Repayment Performance*, Deep & Deep Publications, Delhi, 1992, 207

126 Jayamaha, R., *Development Banking in Sri Lanka: Coercion or Moral Suasion?* (1991) 9 *International Journal of Development Banking* 6

127 Lee Sheng-yi, *The Monetary and Banking Development of Singapore and Malaysia*, 3rd Ed., Singapore University Press, Singapore, 1990, 122-123

- b) The amount applied for does not exceed twenty times the value of shares owned by the member
- c) the applicant had not defaulted on any previous loan
- d) the applicant has a savings account into which regular deposits have been made
- e) there are no outstanding loans
- f) the crops for which the loan is being used are insured
- g) there are two guarantors
- h) the applicant is the owner of the land or the registered *ande* (share) tenant.<sup>128</sup>

Poor farmers cannot satisfy all these criteria and the result is that they are effectively excluded from accessing credit from institutions.<sup>129</sup>

Credit must also be prompt and adequate. The lending decision must be taken quickly and the loan funds disbursed when a borrower needs the funds. A principle of credit appraisal is that loans are granted only to creditworthy borrowers. Very often, small borrowers are not considered creditworthy either because of their inability to provide security or because they have defaulted in the past. As a result, only financially stable farmers succeed in obtaining loans.<sup>130</sup> This is socially unjust. The fact that a small farmer may be able to provide less security does not mean that he is less productive and unable to repay his loan. The reason for default may have been that he had to pay high interest rates on his loan or that the money earned by production was diverted towards satisfying a more pressing need.

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128 Southwold-Llewellyn, S., *Some Explanations for the Lack of Borrower Commitment to Specialised Farm credit Institution: A Case Study of the Role of Rural Sri Lankan Traders In Meeting Credit Needs* (1991) 15 *Savings and Development* 290-291

129 In a community study carried out in Sri Lanka, only 4 out of 143 families were eligible to apply for these loans. *Ibid.*, 291

130 Baharuddin, A. H., Cheema, S., and Yaacob, H., (Eds.) *Credit and Rural Development*, University Sains Malaysia, Kuala Lumpur, 1978, 28

Loan documentation is also complicated for a village borrower. Filling of loan applications, providing proper security documents and the long procedures to have the loan approved create a psychological inhibition among borrowers from taking loans from credit institutions. A rural borrower would consider the loan processing inconvenient, bureaucratic and uncertain. He will also not consider obtaining loans from an institution because it would be incapable of supplying credit when needed. On the other hand, a private moneylender may lend credit purely on the personal knowledge of a borrower. He may even lend to a person who has defaulted earlier, because the lender was aware of the circumstances in which that person had defaulted.<sup>131</sup>

Institutions provide loans only for productive purposes. Poor people are unable to distinguish between credit given for productive purposes and for consumption. If the need for consumption were more urgent, the credit granted for productive purposes would inevitably be used up.<sup>132</sup> A moneylender will grant loans for both productive and non productive purposes because he understands that a poor villager's production and consumption needs are intricately bound together and cannot be separated.

Another practical difficulty faced by poor borrowers is that they cannot reach the banks easily. They have to walk for hours or travel by bus to reach them. The restricted hours for which banks are open would also not be convenient.<sup>133</sup>

Clearly, rural people have a continued preference to borrow from the informal sector. Bankers themselves do not have the required motivation to encourage the rural

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131 Narula, R. K., and Gopalakrishnan, V., *Agricultural and Rural Advances by Commercial Banks*, UDH Publishers, Delhi, 1982, 36

132 David, C., and Meyer, R., "*Measuring the Farm Level impact of Agricultural Loans*" in Howell, J., (Ed), *Borrowers and Lenders*, ODI, London, 1980, 202-203

133 In India the banking hours are 10.30 a.m. - 3.30 p.m. and in Sri Lanka, banking hours are 9.30 a.m. - 1.30 p.m.



poor to borrow from the banks.<sup>134</sup> Lending to the rural sector is costly to a banker because administering a large number of loans of small value and at low interest rates is not profitable. Obviously, the workload of lending to a large number of small borrowers is greater than lending to fewer larger borrowers. The high rates of default among small borrowers also discourage bankers from lending to them because the performance of a branch is judged by its profits.<sup>135</sup> In the event of default, debt recovery is a very slow process and more difficult due to communication difficulties with borrowers. Loan supervision, which is a key element of a lending transaction, is also difficult. Due to these problems the bankers' attitude towards lending to rural borrowers is not encouraging. Banking institutions are primarily geared to operating in an urban environment and most often fail to understand the needs of the rural villager. The loans are given for a short term, for the purpose of production and are usually inflexible with a strict repayment schedule. The relationship between a borrower and a lender ends with this type of single transaction.

### 3.6.2 *Banking for the Poor*

What could banks do to improve the disbursement of credit to the poor? In all three countries, a number of banks have set up credit schemes to direct credit to the rural poor, but they have not achieved the intended success.<sup>136</sup> A common complaint about institutional credit is that the loan process has too many formalities, which poor

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134 Munasinghe, C., *Banking for the Poor: Policies, Problems and Prospects*, Paper Presented at the SLAAS Seminar on Banking for the Poor, Colombo, 1990, 6

135 Sanderatne, N., *Banking for the Poor* (1991) 17 *Economic Review* 3

136 Rangarajan, C., *Banking With the Poor* [1994] *RBI Bulletin* 353; Watawala, L., *Financial Innovations for the Rural Poor: The Asian Experience* (1991) 17 *Economic Review* 6-8, & 15; Pang Yok, J., and Savarimuthu, N., *Banking in Malaysia*, Longman, Kuala Lumpur, 1985, 125-128

borrowers found to be too complex. The lending process, therefore, must be made simpler so that borrowers would have no inhibitions about applying for a loan and having it approved. It is equally important that there is flexibility in the terms of the loan and in the repayment schedule. For example, if a farmer borrows money to buy seed the loan repayments would be dependent on the crops he harvests. As Gunasekera observed:

“The fact that the crop and not the farmer is made the focal point in all credit schemes so far operated is a fundamental conceptual default. Credit has been considered as an important input in increasing the yields of a particular crop and not as an input to increase the production potential of the farmer through whom the yields are to be increased.”<sup>137</sup>

Credit must be directed to the borrowers with genuine financial needs. These borrowers must be identified correctly so that the loans granted by banks will ease their financial needs.<sup>138</sup> The availability of security should not be a requirement in rural lending because most often small borrowers do not have security to offer. The question that banks should ask themselves is not what they are lending against, but what they are lending for. Wells’ study of the informal rural credit market in Malaysia concluded that the credit institutions have predominantly acted as “loan windows” to disburse subsidised credit.<sup>139</sup> He also states that the “lions share” of concessionary formal credit was given to farmers with land holdings, while small farmers resorted to informal lenders for their credit requirements.<sup>140</sup> If the productive activity the loan was given for

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137 Gunasekera, R., “*Institutional Credit to the Peasant Sector Through Co-operatives*” in Samarasinghe, S.,(Ed.) *Agriculture in the Peasant Sector of Sri Lanka*, Ceylon Studies Seminar, Peradeniya, 1977, 49, at 51

138 Yaron, J., “*What Makes Rural Finance Institutions Successful?*” (1994) 9 *The World Development Research Observer* 49-70

139 Wells, R., *The Informal credit Market in Malaysia*, Faculty of Economics and Administration, University of Malaya, Kuala Lumpur, 1980, 7

140 Ibid.

has the potential to generate an income, and it is within the repayment capacity of the borrower, loans must be granted.

The low interest rates charged under most of the credit schemes make them an unprofitable and costly service if default occurs.<sup>141</sup> As a result, lenders are overcautious when lending decisions are made, and are always concerned about institutional viability. Therefore, low interest policies encourage lenders to select potential borrowers who can provide security which in turn results in better to do borrowers receiving concessional credit. In Taiwan, “realistic” interest rates helped to ensure that the loan capital was employed for the productive purpose it was borrowed.<sup>142</sup> In Indonesia, *Kupedes*, a credit scheme designed to provide loans for either investment or working capital to poor individuals charged an interest rate that covered the costs of funds, transaction costs, a reserve for bad debts and a profit margin. The repayment rate was 98%.<sup>143</sup> A completely different result was seen in Malaysia when the government decided to give an interest subsidy to poor farmers through the Malaysian Agricultural Bank (BPM). In 1981, the BPM reduced the interest on paddy loans to 0% and later marginally increased it to 4%. Ishak Shari explains the outcome of the programme as follows:

“When the uncollected principal and the opportunity cost of the interest rate subsidy were taken into consideration, it was estimated that the total subsidy cost ranged from RM10 million to RM24.9 million per annum during the 1980-1985 period. The persistently high level of arrears and negative spreads has left BPM in a precarious financial position requiring an annual grant from the government of about RM30 million.”<sup>144</sup>

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- 141 Adams, D., and Von Pischke, J., *“Microenterprise Credit Programs: Deja Vu”* (1992). 20 *World Development* 1463-1470; Ellis, F., *Agricultural Policies in Developing Countries*, Cambridge University Press, Cambridge, 1992
- 142 Johnston, B., and Kilby, P., *Agriculture and Structural Transformation*, Oxford University Press, Oxford, 1975, 314
- 143 Schrader, H., *Formal and Informal Finance in Contemporary Indonesia, South East Asia Working Programme Working Paper No. 213*, University of Bielefeld, 1994, 6
- 144 Ishak Shari, *Rural Development and Rural Poverty in Malaysia*, in Jamilah Ariffin

A poor person's credit need cannot be compartmentalised into production and consumption needs. Empirical research has shown that rural borrowers use institutional loans to defray the costs associated with consumption.<sup>145</sup> A more practical approach to adopt would be to provide credit for productive as well as consumption needs. It must be borne in mind however, that the main purpose of providing credit is the promotion of economic activity. Operating a proper credit plan may assist in achieving this objective where the poor borrower would be able to satisfy all his credit needs from a banking institution, rather than from a private money lender. Lack of enthusiasm on the part of bankers to lend to the poor is one of the weakest institutional obstacles to rural lending.<sup>146</sup>

### 3.6.3 *New Approach To Rural Lending*

The formal financial sector has failed to diagnose and solve the problems faced by rural borrowers. What is needed is a new approach to rural lending with personalised banking as the prime feature. It will essentially require the assistance of semi or non governmental organisations to act as the local agents of the banks and to introduce institutional borrowing to the rural sector. These organisations can work as intermediaries between lenders and borrowers and effectively breakdown the existing obstacles faced by both parties. The main advantage to banks is that the entire credit

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(Ed), *Poverty Amidst Plenty*, Pelanduk Publications, Kuala Lumpur, 1994, 45

<sup>145</sup> David, C., and Meyer, R., *Measuring the Farm Level Impact of Agricultural Loans*, in Howell, J., *Borrowers and Lenders : Rural Financial Markets and Institutions in Developing Countries*, ODI, London, 1980, 202-203; Floro, S., and Yotopoulos, P., *Informal Credit Markets and the New Institutional Economics: The Case of Philippine Agriculture*, Westview Press, Oxford, 1991, 79-80

<sup>146</sup> Rangarajan, C., *Rural India: The Role of Credit* [1996] RBI Bulletin 295; Fernando, N., and Nanayakkara, C., *The Rescheduling of Cultivation Loans : Field Observations from the Anuradhapura District* (1984) 14 Central Bank of Sri Lanka Staff Studies 121

cycle becomes externalised. Credit appraisal, loan documentation, loan supervision and debt recovery can all be facilitated effectively by linking banks and borrowers.

‘People’s participation’ is the underlying concept of credit disbursement in this manner. This approach has been tried in several developing countries and it has proved to be very successful.<sup>147</sup> An attempt made by the National Bank of Agriculture and Rural Development in India to link banks with rural borrowers through “self-help groups” has also proved to be very successful. Over two thousand groups managed to secure loans and the repayment performance was 95% as compared to 50% in the case of normal bank lending.<sup>148</sup> In Sri Lanka, a number of similar schemes have been implemented. *Gam Pubuduwa* (Village Awakening) and *Praja Naya Niyamaka* (People’s Loan Intermediary Scheme) are two examples. In the *Gam Pubuduwa* scheme, “*Upadeshakas*” (Advisors) are recruited and trained to identify projects in villages which require credit and then assist in providing the required credit. The objective of the scheme is to provide “bare foot banking”.<sup>149</sup> In the *Praja Naya Niyamaka* scheme, about 7000 local agents have been recruited to act as intermediaries to select creditworthy borrowers and assist them with obtaining credit.<sup>150</sup> In Malaysia, institutions such as the Farmers’ Organisation Authority, and the Fisheries Development Authority assist poor people to organise and consolidate themselves into rural credit co-operative societies so that funds channelled by the government may be productively utilised by the loan recipients. Other rural development institutions include MARA, i.e.

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147 *World Development Report*, Oxford University Press, New York, 1989, Chapter 8

148 Rangarajan, C., *Rural India: The Role of Credit* [1995] RBI Bulletin 296

149 Jayamaha, R., and Wilson, P., *Development Banking in Sri Lanka: Coercion or Moral Suasion?* (1991) 9 International Journal of Development Banking 8

150 Watawala, L., *Financial Innovations for the Rural Poor: The Asian Experience* (1991) 17 The Economic Review 7

the Council of Trust for Indigenous People and the Federal Agricultural Marketing Authority.<sup>151</sup>

The problems associated with this type of scheme must not be ignored.<sup>152</sup> First, despite the keenness to implement credit schemes through people's participation, there must be a proper administration mechanism to carry out the scheme. Non governmental organisations, voluntary organisations, and self-help groups must have the necessary administrative capabilities to carry out the role of providing an effective link between institutional lenders and rural borrowers. Second, these organisations must be supervised by a central body, to which they must be accountable. Since these organisations are involved in credit disbursement, the central banks would be the appropriate bodies to supervise their functions.

The moral obligations of borrowers play an important role in this type of scheme. For example peer pressure is used to encourage loan repayments.<sup>153</sup> Group lending schemes are seen in Bangladesh, Malawi, Nepal, Ghana, and Zimbabwe where, borrowers are organised into groups and apply for a loan as a single group and share the responsibility of repaying the loan.<sup>154</sup> In some instances, women are the preferred recipients of loan funds, because they are known to successfully shoulder the burden of

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151 Lee Sheng-yi, *The Monetary and Banking Development of Singapore and Malaysia*, 3rd Ed., Singapore University Press, Singapore, 1990, 123-124

152 Ryan, P., *Barriers to Introducing Group Lending to Small Farmers: The Case of the Mahaweli Development Programme in Sri Lanka*, Discussion Paper No. 60, Development and Planning Centre, University of Bradford, 1995

153 Wickrama, K., and Keith, P., *Savings and Credit : Women's Informal Groups as Models for Change in Developing Countries* (1994) 28 *Journal of Developing Areas* 365

154 Hupi, M., and Feder, G., "The Role of Groups and Credit Co-operatives in Rural Lending" (1990) 5 *The World Bank Research Observer* 187-207

their family's survival needs.<sup>155</sup> For example, research has shown that for every 100 rupees earned by an Indian woman 92 rupees is used for children, education and health. By contrast, a man spends only 40 rupees on such needs.<sup>156</sup> In India, under the integrated Rural Development Programme (IRDP) 40% of the beneficiaries have to be women. Similarly, in Bangladesh 75% of the loan recipients from the Grameen Bank are women. In Indonesia, under the Badan Kredit Kecamatan scheme money is mostly lent to middle aged peasant women.<sup>157</sup>

### 3.7 CONCLUSION

Credit allocation and control can be more effective in all three countries. There are no easy solutions to reduce the problems faced by lenders, but the introduction of specific measures may improve the existing situation.

In India and Sri Lanka, banks will consider a loan application favourably only if the borrower can provide security. It is indeed an inflexible banking practice to follow, because it effectively cuts access to credit to poor borrowers who would be unable to provide security. If a banker assessing the credit worthiness of a borrower is of the view that there is an element of doubt as to the repayment capacity of a borrower, security must be taken. However, to insist on security irrespective of all other criteria being satisfied raises the question whether, in practice, effective credit assessment is limited to checking if the borrower could provide adequate security? In Malaysia, when small

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155 Singh, S., *Rural Credit: Issues for the Nineties* [1990] Economic and Political Weekly 2534

156 Statistics quoted by the 'Women's World Banking' at the UN Conference On Women, held in Beijing on 4 September 1995, See Walker, T., and Boulton, L., *Micro Lending Offers Power to World's Poor*, Financial Times of 5 September 1995; Kuper, S., *Safe Bets and Entrepreneurs*, Financial Times of 21 November 1995

157 *World Development Report*, World Bank, Oxford University Press, New York, 1989,

loans are granted, banks would take security only if the borrower's creditworthiness is such that security is required. For larger loans however, banks are compelled to take security by law. In all three jurisdictions, a shift in approach towards assessing the credit worthiness of a borrower is essential whereby the lender will place greater emphasis on the ability of the borrower to repay the loan, rather than on obtaining loan security which at present receives greater attention.

Whether the establishment of private credit reference agencies will assist lenders in their credit appraisal process needs further consideration. There is no legal obstacle to establishing these agencies, but will they be effective in providing up to date information to lenders? The Credit Information Service provided by the Reserve Bank of India, the Credit Intelligence Bureau of Sri Lanka and the Rating Agency of Malaysia all seem to be functioning quite well and provide an adequate service. It is therefore doubtful whether there is a pressing need for the establishment of private rating agencies. Even in countries like the United Kingdom obtaining information from such agencies does not appear to be popular. In a survey that was carried out among 252 banks, it transpired that 76% of the banks occasionally or never used these agencies to obtain credit information.<sup>158</sup>

In India and Sri Lanka, only a court of law could decide if a loan transaction is harsh and unconscionable, but in Malaysia the law specifies the maximum rate of interest that can be charged on secured and unsecured loans. Lenders will, no doubt, feel more confident when negotiating the interest rate with potential borrowers where there is guidance as to whether the transaction is likely to be challenged as a harsh and

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158 Berry, A., Faulkner s., Hughes, M., and Jarvis, R., *Bank Lending: Beyond the Theory*, Chapman & Hall, London, 1993, 76 and Table 6.1



unconscionable contract.

In India and Sri Lanka, there is a need for strong well drafted documentation which are written clearly, free of mistakes and obvious omissions so that parties could understand its contents. It is quite acceptable to use standard forms for certain types of loans particularly, if the loan transaction is straight forward, as it reduces the cost of borrowing. However, a distinction must be made when the loan transaction is more complex. Unfortunately, lawyers are not involved in preparing security documents or in negotiating and finalising loan agreements and as a result the legal interest of lenders are not adequately protected. Badly drafted documents become the basis of numerous disputes because borrowers themselves do not understand the jargon they have signed. An Australian court once observed that it was regrettable that the bank's mortgage forms were "long and involved documents" which did not take into consideration certain decisions of the courts and comments of well known academic writers. Referring to the complexity of the bank's mortgage deed, Fox J remarked,

"It surely is a sad commentary on the operation of our legal system that a borrower should be expected to execute a document which only a person of extraordinary application and persistence would read, which if read is virtually incomprehensible and which, in any event, has a legal effect not disclosed by its language<sup>159</sup>.

The need for loan supervision is mostly needed in India and Sri Lanka where the proportion of non performing loans is currently very high. India appears to be aware of the need to supervise loans and a number of credit monitoring schemes are in operation. If the Health Code can be revised where the criteria laid down for the classification of borrowers is practicable rather than being idealistic, the system may be a useful guide for the purpose of follow up action. Of course, the effectiveness will also depend on the seriousness and sincerity of bank officials. The Service Area Approach could be effective if the bank

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159 *Richard v Commercial Bank of Australia* (1971) 18 FLR 95, at 99-100

officers are successful in integrating with the rural borrowers so that correct information is obtained as to whether the loan funds were utilised properly. In Sri Lanka, the response to the debt recovery problem has been to provide "fast track debt recovery methods."<sup>160</sup> Thus the emphasis has been to provide remedies for the problem. It is equally important that attention is given to finding out the causes of default if a long term solution to the debt recovery problem is to be found. Credit supervision is an important method of finding out these causes.<sup>161</sup> Central Bank must therefore take the initiative to appoint a committee to study the problem further. Important lessons may be learnt from the extensive research carried out in India, a country with similar social and economic problems.

The informal sector continues to play a prominent role in providing credit to the rural borrowers. Credit appraisal by an institutional lender involves collecting personal information about borrowers, the purpose for which the loan has been applied and determining the availability of security. To build personalised knowledge about borrowers in rural areas is a difficult task for a credit institution. Loan documentation is another aspect that rural borrowers find difficult to comply with. The loan agreement will state the terms of the loan and a strict repayment schedule is usually included. As one farmer observed "the government wants paddy and money on an exact date. If you default, you must go to court."<sup>162</sup>

Supervising the progress of loan funds granted to rural borrowers is not easy due

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160 In 1990, The Debt Recovery (Special Provisions) Act, No. 2 of 1990 and The Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 together with 14 other amendments to various statutes were enacted.

161 Silva, K., *Supervision, Identification of Alarm Signals, Treatment of Sick Units : Rehabilitation and Restructuring of Loans* [1990] Economic Review 38

162 Southwold-Llewellyn, S., *Some Explanations for the Lack of Borrower Commitment to Specialised Farm Credit Institution: A Case Study of the Role of Rural Sri Lankan Traders In Meeting Credit Needs* (1991) 15 Savings and Development 290, at 291

to geographical constraints and poor communication facilities. Lack of staff committed to rural lending is also a problem for banks. Private moneylenders are obviously better placed to pursue the loan repayments and constantly follow up repayments. The debt is collected “on the spot.” The conclusion that may be drawn is that despite very basic methods of credit appraisal and loan documentation, the rural lender continues to be in the money lending business primarily due to aggressive loan supervision and debt recovery. Contrary to popular belief, a village moneylender may also be a “friend” or “relative” and may not always be the extortionate trader trying to usurp an advantage from a poor person. The acting Secretary General of the Asian Pacific Regional Agricultural Credit Association has noted,

“In most of the countries, the informal credit agencies like money-lenders still play a prominent role in providing credit to the rural people. The very fact that they like to borrow money from such agencies despite prohibitive rates of interest, indicates that the formal credit system is not flexible enough to provide to the rural people credit services of the type they need. On the other hand, the informal credit agencies are reportedly have little problem of loan collections thanks to the personalised approach and precautionary measures adopted by them. It may perhaps be worthwhile for the banks to study the policy procedures and systems of informal credit agencies for lending and collections”<sup>163</sup>

Specific changes alone are not adequate to resolve the existing problems. The administration of the entire loan transaction must be streamlined. It is essential that more resources are spent on training bank officers and lawyers who will improve the quality of credit appraisal, loan documentation and supervision. In addition, political interference on lending decisions must be stopped. As Yash Ghai puts it: “The ideological strength of legality comes from the appearance of even-handedness of the

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<sup>163</sup> Quoted in Southwold-Llewellyn, S., *Some Explanations for the Lack of Borrower Commitment to Specialised Farm Credit Institution: A Case Study of the Role of Rural Sri Lankan Traders In Meeting Credit Needs* (1991) 15 *Savings and Development* 285, at 293 foot note 9

legal system and of the equal application of the laws to all, including top leaders.”<sup>164</sup>

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<sup>164</sup> Ghai, P., *The Rule of Law, Legitimacy and Governance*, in Ghai, Y., et al., *The Political Economy of Law*, Oxford University Press, Delhi, 1987, 254

## CHAPTER FOUR

### ***ENFORCEMENT OF SECURITY***

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- 4.1 *INTRODUCTION*
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    - 4.8.5 *Restriction on Receiver's Powers in Malaysia*
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    - 4.8.6 *Muslim Culture in Malaysia*
  - 4.9 *CONCLUSION*
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#### 4.1 *INTRODUCTION*

Lenders may extend credit to borrowers with or without security. If the reputation or record of a borrower reassures a lender sufficiently that the money will be repaid, it may be prepared to extend credit without security. In all other cases a lender

will demand some form of security as a safeguard against a risk that the borrower may not be able to repay the loan, or be forced into insolvent liquidation proceedings. By taking security the immediate benefit to a lender is the reduction of risk against default, but it will also have a greater economic benefit in the long term.<sup>1</sup> Where security is provided, a lender may be willing to authorise a loan more easily. It may also be prepared to offer lower interest rates, extend longer periods for which the loan is granted and if necessary, increase the amount of the loan.<sup>2</sup> Favourable lending terms will inevitably result in a better flow of credit to the economy, leading to increased investment and growth rates.<sup>3</sup>

A lender's objective of taking security is to recover a debt granted to a borrower if it defaults under a loan agreement. A borrower granting security to a lender must therefore diligently keep to his repayment schedule, or run the risk of the lender enforcing its rights if it defaults. In the event of insolvency of a borrower, a lender with security will be considered a secured creditor, and stand outside the insolvency proceedings. For this reason, secured creditors are often called super-priority creditors. By contrast, creditors who are unsecured would receive little or nothing through the rateable distribution process employed in such proceedings.<sup>4</sup>

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1 Flesig, H., *The Power of Collateral* in *The World Bank : View Point*, No 43, World Bank, 1995; Flesig, H., *The Right to Borrow*, in *The World Bank: View Point*, No. 44, World Bank, 1995

2 Simpson, J., and Rover, J., *General Principles of a Modern Secured Transactions Law*, in Norton, J., and Andenas, M., (Eds.), *Emerging Financial Markets and Secured Transactions*, Kluwer Law International, London, 1997, 143, 144

3 Professor Diamond observes:

"Modern business depends on credit. Although the over extension of credit is not to be encouraged, responsible credit helps the economy and, in business transactions security contributes to the more responsible use of credit"

Diamond, Prof. A.L., *A Review of Security Interests in Property*, HMSO, London, 2

4 Goode, R., *Principles of Corporate Insolvency Law*, 2nd Ed., Sweet and Maxwell,

If lenders find it difficult to enforce security and recover their debts, the objective of taking security will prove to be useless. If on the other hand, the security enables the lenders to recover debts quickly without following a cumbersome process, the security will be more valuable to a lender. As Mather observes,

“Security is taken as an insurance in case of need and it must always be remembered that the test of any sound insurance is that it should be available, readily realisable and sufficient when required. Nothing is more disconcerting than to find that the security, taken as an insurance against the unexpected, is inadequate or cannot be realised when it is most needed.”<sup>5</sup>

In many developing countries including India, Sri Lanka and Malaysia, lenders rarely grant credit without security. Land is the preferred form of security<sup>6</sup> and lenders are hesitant to accept tangible movable properties, stocks and current assets, account receivables and book debts, livestock, etc. as collateral,<sup>7</sup> not least because the law does not provide much protection for intangible security. If such security is to be accepted, an additional personal guarantee may be demanded. This practice makes it difficult for

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London, 1997, 143-144, 151-161; Fletcher, I., *The Law of Insolvency*, 2nd Ed., Sweet and Maxwell, London, 1996, 613-616

<sup>5</sup> Mather, L., *Securities Acceptable to the Lending Banker*, Waterlow and Sons Ltd., London, 1960, 1

<sup>6</sup> Exception are the socialist countries where land is owned by the state or private ownership is limited, and countries where only part of the land is alienated and the rest held by the community under customary law. Hiscock, M., *Law and Political Change : Land Use by Foreigners in Socialist Countries of the Third World* in Cranston, R., and Good, R., *Commercial and Consumer Law*, Clarendon Press Ltd., Oxford, 1993, 292

<sup>7</sup> Sri Lanka : Interview with Mr. M. Fernando, Deputy General Manager Credit Department, Peoples' Bank Headquarters, Colombo, at the Bank, on 14 May 1997; Malaysia : Chen Kah Leng, *Country Report For Malaysia*, Paper Presented at the Asian Development Bank Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 16 ; See Generally : Cranston, R., *Credit Security and Debt Recovery : Law's Role in Reform in Asia and the Pacific* in Norton, J., and Andenas, M., (Eds.), *Emerging Financial Markets and Secured Transactions*, Kluwer Law International, London, 1997, 219,239; *How Legal Restrictions on Collateral Limit Access to Credit in Bolivia*, Report No. 13873-BO, World Bank, Washington DC., 1994

anyone without real estate to secure credit facilities for business activities.<sup>8</sup> Farmers working on rented land are also excluded from accessing credit for farming projects thus forcing them to borrow from private moneylenders. The overall effect of these lending policies is that they lead to high interest rates, low volume of lending and low investment in the countries.

Why do lenders consider security over movable property more risky than loans secured by real property? To a lender, this type of security has some inherent weaknesses for which there are little or no legal remedies. Some types of movable property may depreciate in value with time, and the economic value of the security may have reduced by the time of enforcement. The absence of inefficient registries makes it extremely difficult for lenders to trace movable property subject mortgages. Sometimes it is impossible to identify before a court the exact property which bears a security interest. By contrast, the delays experienced in enforcing real security will not reduce the economic value of the property significantly. Further, problems related to identification will not arise, and the problems connected to land registration are comparatively few.

Despite the advantages of taking real security, lenders face a number of problems when such security is taken. The laws provide for a wide range of securities, but lenders are forced not to execute certain forms of securities due to varying legal constraints. High stamp duties payable on certain security instruments, effectively restrict lenders from using such forms of security. India provides a good example. Shroff observes,

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<sup>8</sup> Flesig, H., *The Right To Borrow : Legal and Regulatory Barriers that Limit Access to Credit by Small Farms and Businesses*, The World Bank : View Point, No. 44, World Bank, Washington DC., 1995



“Legal innovativeness has unfortunately had to be deployed in order to side step these unreasonable levies based on short sighted policies. The impact of such duties in restricting development by choking financial transactions, and movement of capital has been under estimated.”<sup>9</sup>

Generally, the methods of enforcement are complex and most often require the secured creditor to obtain a court order. In most developing countries, the court systems are inefficient, slow and follow protracted procedures that result in unreasonable delays in issuing judgements and their enforcement.<sup>10</sup> Delinquent borrowers often exploit these weaknesses in a system by raising spurious defences at the trial or challenging the enforcement procedures to delay the eventual realisation of the secured assets.

In this chapter, it is proposed to examine the range of security which is available to lenders in India, Sri Lanka and Malaysia, their enforcement and the problems encountered in the enforcement process.

#### 4.2 RANGE OF AVAILABLE SECURITY IN INDIA

The majority of lenders in India are prepared to give credit to potential borrowers only if they are able to provide adequate security to cover the principal money advanced and the interest. The laws provide for a wide range of security devises that lenders may take over immovable as well as movable property. There are however, several legal as well as practical difficulties that restrict the free use of these forms of security.<sup>11</sup> Creating mortgages over immovable property involves numerous procedural formalities, the most important two being registration of the mortgage (except in

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<sup>9</sup> Shroff, C., *India Country Report*, Presented at the Asian Development Bank Symposium on Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 22

<sup>10</sup> Shihata, I., *The World Bank In a Changing World : Selected Essays and Lectures*, Vol. II, Martinus Nijhoff Publishers, Dordrecht, 1995, Chapter 4

<sup>11</sup> Hegde, S., *Mortgage* (1995) 66 *The Journal of the Indian Institute of Bankers* 115

equitable mortgage) and obtaining tax clearance by the relevant authorities.<sup>12</sup> Most mortgage instruments require to be stamped as well. According to the Indian Stamp Act 1889, stamp duty is payable not on a particular “transaction” but the “instrument,” thus lenders avoid using forms of security that need to be stamped.

#### 4.2.1 Security Over Immovable Property

The Transfer of Property Act 1882 governs the law of property. A mortgage created over real property is the most acceptable form of security to a lender.<sup>13</sup> Indian law recognises six types of mortgages.<sup>14</sup> They are: a simple mortgage; mortgage by conditional sale (equitable mortgage); usufructuary mortgage; English mortgage; mortgage by deposit of title deeds; and anomalous mortgage.

A *simple mortgage* is created when the mortgagor personally undertakes to pay the mortgage money, and expressly or by implication agrees that in the event of default the mortgagee shall have the right to sell the mortgaged property and utilise the sale proceeds to settle the outstanding mortgaged debt.<sup>15</sup> In a simple mortgage, the mortgagee is not given possession of the property nor is he given the ownership of the property. The mortgagee’s right to sell the property is subject to obtaining an order from a civil court directing the sale.

A mortgage by *conditional sale* is in fact, as the name clearly suggests, a form

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<sup>12</sup> Kolarkar, S., *Paper Presented at the ADB Symposium on Legal Aspects of Debt Recovery, Credit and Security*, (Unpublished), Manila, 1993, 18

<sup>13</sup> Section 58(a) of the Transfer of Property Act 1882, defines a mortgage as the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan or an existing or future debt or the performance of an engagement which may give rise to a primary liability.

<sup>14</sup> Section 58 (b)-(f) ; Nath, B., *Cases and Materials on The Transfer of Property Act 1882*, Eastern Law Book Co., Lucknow, 1987, 347-390

<sup>15</sup> Section 58(b)

of sale upon a condition. The mortgagor "ostensibly" sells the mortgaged property on condition that in default of repayment by a certain date the sale shall become absolute, or on payment being made the sale shall become void.<sup>16</sup> Clearly, there is an "ostensible" transfer of ownership of property on default of payment. In 1929, the law was amended by adding a proviso to section 58(c) which states that an "ostensible sale" shall not be regarded as a mortgage, unless the stipulation for repurchase is contained in the very document which effects the sale.<sup>17</sup> There has been much controversy over this amendment particularly, on the question whether a provision in a deed of sale for repurchase by the borrower is presumptive evidence of a mortgage.<sup>18</sup>

The Indian Law Commission recommended that this section requires clarification, and suggested that section 58(c) should clearly state that, the embodiment of a condition for re transfer in the document of sale would not, by itself, be evidence of a mortgage.<sup>19</sup> So far this recommendation has not been given effect to by the Indian legislature. Lending institutions rarely accept this type of mortgage, and the reason may be the uncertainty that shrouds the interpretation of the statutory provision.

An *usufructuary mortgage* is created when a mortgagor delivers or agrees to deliver possession of the mortgaged property to the mortgagee, and agrees with the

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16 Section 58(c)

17 The Indian Supreme Court has held that, after the 1929 amendment, if the parties chose to incorporate this term in the same document, i.e. the document in question and not by a separate document, the presumption that inevitably follows is that their intention was to take a document of mortgage by conditional sale. *Chunchun Jha v Ebadat Ali* [1954] AIR (SC) 345

18 In *Janki Devi v Mt. Murta Kuer Agrawal* J held that, if the condition is incorporated in the deed, a reasonable inference may be drawn with respect to the intention of the parties to create a mortgage and that this inference may be displaced. [1974] AIR (Patna ) 246 at 247

19 *Seventieth Report of the Law Commission on the Transfer of Property Act 1882, 1977*, Sadar Patel Marg., Allahabad, 1977, 400

mortgagee that he is entitled to use the usufruct until the principal sum and interest are paid. This type of mortgage is not a useful form of security for a lender and is hardly used in banking transactions.<sup>20</sup>

An English *mortgage* is defined in the Act as an agreement whereby the mortgagor binds himself and transfer the mortgaged property absolutely to the mortgagee subject to the condition that the property will be re-transferred to the mortgagor upon repayment of the mortgage loan.<sup>21</sup> In an English mortgage the mortgagor transfers the property "absolutely" to the mortgagee, but the general definition of a "mortgage" in the Transfer of Property Act states that a mortgage is a transfer of an interest in specific movable property.<sup>22</sup> In 1939, the Privy Council decided that in an Indian English *mortgage* the transfer would be absolute but for the proviso for re-transfer, thus dispensing with this apparent inconsistency.<sup>23</sup> It may then be said that although the word absolute is used in section 58(e) only the mortgagor's interest is transferred subject to the right of redemption.

An *equitable mortgage* is created where a debtor delivers to his creditor or his agent, documents of title to his immovable property with an intention of creating a security for the money that was or would be advanced to him by the creditor.<sup>24</sup> To create a valid *equitable mortgage* the title deeds to the property must be deposited with the lender, with a clear intention of creating security. The mortgage can be entirely oral and does not require registration. A written document is not required to create such a

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20 Section 58(d)

21 Section 58(e)

22 Section 58(a)

23 *Ramkinar v Satyacharan* [1939] AIR (PC) 14

24 Section 58(f)

mortgage because it is created by the act of depositing the title deeds. The law however, does not prohibit such a document being executed. *Equitable mortgages* can be created quickly and without much expense because they need not be registered. They also do not require to be stamped hence, it would be an ideal form of security for a lender to take. Unfortunately, *equitable mortgages* can be created only in certain specified towns in India which have been notified in the official Gazette by the Government. (e.g. Bombay, Calcutta, Madras)

A form of mortgage that cannot be defined as any one of the five discussed above is called an *anomalous mortgage*. Possibly, these are forms of mortgages based on local customs and practice, and are of little use to a commercial lender.<sup>25</sup>

#### 4.2.2 *Security Over Movable Property*

Movable property is commonly used as a form of security, and is generally given by way of *pledge or hypothecation*.<sup>26</sup> The substantive law governing a *pledge* is the law of contract and not property law. A pledge is a possessory security taken over movable property. Actual or constructive delivery of the property is essential to its validity. In *Official Assignee of Madras v Mercantile Bank of India*, Lord Writ explained,

“At the common law a pledge could not be created except by a delivery of possession of the thing pledged, either actual or constructive. It involved a bailment. If the pledgor had the actual goods in his physical possession, he could effect the pledge by actual delivery: in all other cases he could give possession by some symbolic act, such as handing over the key of the store in which they were.”<sup>27</sup>

In modern commercial lending constructive delivery will constitute the delivery of a

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25 Section 58(g)

26 Indian Contracts Act, 1872, Sections 172- 181

valid document of title which represents the goods such as a bill of lading, or an acknowledgement (called an attornment) by the warehouse keeper that he holds the goods to the order or disposition of the bank.<sup>28</sup> The right to the property pledged is with the pledgee but this right is limited to the extent of the debt that is due.

The Indian law on pledges is quite advanced and its enforcement not difficult. For example, "key loan" arrangements are recognised in India. In a key loan arrangement, the property that is pledged is under the control of the lender possibly in its warehouse, and released to the borrower as and when required by the borrower.<sup>29</sup>

*Hypothecation* is not defined by any Indian statute, but it is generally explained as a mortgage of movable property without the mortgagee being given actual possession of the property.<sup>30</sup> There is an assumption that the mortgagee has "constructive possession" of the property which has now been construed as having "legal possession".<sup>31</sup> Although Indian statute law does not recognise this type of security, the Indian courts have recognised it.<sup>32</sup> In *Bank of India v S.B. Shah Ali* court observed:

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27 [1935] AC 53, at 58

28 In *Dublin City Distillery (Great Brunswick Street, Dublin) Ltd v Doherty*, court held that the delivery and receipt of a warrant does not *per se* amount to a delivery and receipt of the goods. Lord Atkinson said,

"The warehouseman holds the goods as the agent of the owner until he has attorned in some way to this person and agreed to hold the goods for him; then and not till then does the warehouseman become a bailee for the latter, and then and not till then is there a constructive delivery of the goods." [1914] AC 823, 847

29 *Bank of Maharashtra v Official Liquidator* [1969] AIR (Mys) 280

30 Shroff C.S. *India Country Report*, Paper Presented at the Asian Development Bank Symposium on Legal Issues in Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 29- 30

31 Abichandani, R., (Ed) *Pollock and Mulla on Indian Contract and Specific Relief Acts*, 11th Ed., Vol. 11, N.M. Tripathi Private Ltd., 1994, 1053-1054; *Nadar Bank Ltd., v Canara Bank Ltd.*, [1961] AIR (Mad) 326

32 *Bank of Maharashtra v Official Liquidator* [1969] AIR (Mys) 280; *State of Andhra Pradesh v Andhra Bank Ltd.* [1988] AIR (AP) 18

"[The] courts have recognised the principles of common law and rendered justice according to equity and good conscience and therefore that being the law in force, action does lie in the court in respect of a hypothecation"<sup>33</sup>

The use of hypothecations is fairly common among Indian bankers. Non bank institutions have also given loans on security of movable property subject to a hypothecation.<sup>34</sup>

Another form of security which banks favour are *guarantees*, particularly, from corporate borrowers.<sup>35</sup> Generally, personal guarantees are taken from directors of a company or in the case of a group, one company will guarantee the obligation of another company in which they have a strong shareholding. Guarantees are favoured by lenders because if the debtor company becomes insolvent, the bank has a right to institute a separate cause of action against the guarantor without first commencing proceedings against the principal debtor. The reason is that the guarantor's liability does not cease as a result of the debtor becoming insolvent. This right of the lender can be waived by the parties by entering into a contract to the contrary. It must be noted that the Reserve Bank of India has directed banks not to obtain personal guarantees from company directors if it is satisfied about the debtor company's financial stability and management.<sup>36</sup> The statutory provisions that govern guarantees in India are seen in the Indian Contract Act, 1872.<sup>37</sup>

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33 [1988] AIR (AP) 18, 23

34 Kothari, V., *State Bank of India v S.B. Shah Ali : Right to Repossess Assets Exists in Hypothecation Too* (1998) 13 JIBL 34, 35

35 A Guarantee is an accessory contract, not a primary contract and therefore a surety's liability to the to the creditor does not arise until the principal debtor defaults - See Goode, R., *Legal Problems of Credit and Security*, 2nd Ed., Sweet and Maxwell, London, 1988, 188

36 Tannan, M., *Tannan's Banking Law and Practice in India, 19th Ed.*, India Law House, New Delhi, 1991, 525

37 Sections 124-147

The *floating charge* is a creation of the English Equity Courts of the 19th Century<sup>38</sup> and is now recognised in a number of common law countries. Indian law recognises the creation of a floating charge by a corporate borrower in favour of a lender, as a means of security for money lent to it.<sup>39</sup> In the absence of special statutory provisions, floating charges can only be created by companies that are governed by the Companies Act of 1956. Where a company creates a floating charge, it must be registered with the Registrar of Companies within 30 days of its creation. Failure to do so would make the charge void against the liquidator or any creditor of the company in the event of a winding up.<sup>40</sup> The primary objective of registration is to show other creditors inspecting the register to what extent the company's assets are encumbered or unencumbered, which in turn would reflect the company's creditworthiness.<sup>41</sup>

The trust receipt is a creation of international banking practice. When importers and exporters of goods need to raise finance from their banks, the use of *trust receipts* plays an important role. A trust receipt is a document by which the bank's customer, the pledgor, acknowledges that it holds the goods and the proceeds of the sale on trust for the bank.<sup>42</sup> A trust receipt allows a lender to part with the documents of title to the goods pledged without forfeiting its rights as pledgee so that the borrower can take delivery of the goods, and also deal with them as the lender's trustee. When goods are being imported, a buyer will normally pledge the shipping documents to the bank to

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38 *Holroyd v Marshall* (1862) 10 HLC 191

39 *State of Andhra Pradesh v Sri Raja Ram Janardhana* (1965) 2 Comp.LJ 222

40 Section 125

41 *Re Jackson and Bassford Ltd* (1906) 2 Ch 467 at 476 per Buckley J.

42 Hapgood, M., (Ed) *Paget's Law of Banking*, 11th Ed., Butterworths, London, 1996, 563; Gutteridge, H., & Megrah, M., *Law of Bankers Commercial Credits*, 7th Ed., Europa Publications Ltd., London, 1984, 215



obtain finance. The buyer may take delivery of the goods and The bank would then execute a letter of trust and release the shipping documents so that the buyer may take delivery of the goods. Similarly, when goods are being exported a bank may lend money to an exporter to purchase the goods against a trust receipt, if the seller agrees to hold the goods or the sale proceeds in trust for the bank or as agent of the bank. The Indian legislature is silent on the use of trust receipts. The Banking Laws Committee recommended that the law relating to trust receipts be codified so that it will enable banks to play a more effective their role as catalyts of the country's economic development.<sup>43</sup> The Reserve Bank of India prepared the "Banking Companies (Trust Receipt Transactions Bill) based on the Uniform Trust Receipts Act of the United States of America, but the Bill has not been pursued beyond the stage of getting comments from the banks. In practice, financial institutions rarely use this form as security due to its weak legal position. Occasionally, lenders accept trust receipts from borrowers with excellent credit ratings or adequate collateral, to finance imports for short periods, usually between 15-30 days.<sup>44</sup>

#### 4.3 RANGE OF SECURITY AVAILABLE IN SRI LANKA

Like in India, land is the most readily accepted form of security by Sri Lankan lending institutions.<sup>45</sup> It is usually granted by way of a mortgage over the property.<sup>46</sup>

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<sup>43</sup> *Report of the Banking Laws Committee on Personal Property Security Law*, Government of India, Delhi, 1977, Para 1.2.93

<sup>44</sup> Kolarkar, S., *Paper Presented at the ADB Symposium on Legal Aspects of Debt Recovery, Credit and Security*, (Unpublished), Manila, 1993, 22

<sup>45</sup> *Report of the Bank of Ceylon Commission*, Sessional Paper XXVII, Vol. II, Government Printer, Colombo, 1963, Para 198

<sup>46</sup> Weerasooria, W., *Credit and Security in Ceylon (Sri Lanka) : The Legal Problems of Development Finance*, University of Queensland, St. Lucia, 1973, Chapters 5 & 6

Most leading credit institutions in the country, such as the Development Finance Credit Corporation and the State Mortgage Bank will lend only on the security of a primary mortgage. Some credit institutions do take secondary mortgages but only as additional security for further loans they may grant. Private moneylenders and investors however, do accept subsequent mortgages as security for loans granted by them. The law provides for a similar range of securities to those available in India, but lenders do not use all these forms of security. The main cause for this appears to be the uncertainty surrounding its effectiveness.

#### 4.3.1 *Immovable Property as Security*

The law that governs mortgages over real property is the Mortgage Act 1949, (as amended) and Roman Dutch Common Law.<sup>47</sup> The Mortgage Act recognises four types of mortgages. Namely, mortgage by deposit of title deeds, conditional transfer, usufructuary mortgage, and concurrent mortgage.

A borrower may mortgage his land to an approved credit agency by the *deposit of title deeds* with the lender.<sup>48</sup> This form of mortgage facilitates the granting of short-term loans quickly and at low cost. Procedures such as valuations of the land, examinations of title and the execution of the normal instruments of mortgage which

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<sup>47</sup> The Roman Dutch Law of mortgage is fundamentally different from the law of mortgage at English Common Law. In a legal mortgage granted to a lender at English Common Law, ownership of the mortgaged property is transferred to the lender but possession is retained by the mortgagor until repayment in full or until the lender takes steps to sell the property in the event of default. In other words, if the property is sold, the mortgagee sells his own property and not the property of the mortgagor. Under the Roman Dutch Law, the mortgagor does not transfer title of the property to the mortgagee, but continues to retain title in his own hands. Consequently, the mortgagee does not have a right of ownership to the property but only the right to recover payment of the debt. The mortgagee's right is in fact a real security right in the immovable property.

<sup>48</sup> Sections 69 & 70(1) Mortgage Act, *Legislative Enactments of the Democratic*

must be notarialy attested are dispensed with. There is also provision for stamp duty to be paid in instalments. These mortgages are very similar to the equitable mortgages recognised by the Transfer of Property Act in India.

At a glance, this type of security should make credit more freely available to prospective borrowers but lenders in Sri Lanka, like their counterparts in India appear hesitant to use this special form of mortgage. There appear to be at least two reasons. First, the law does not recognise the rights and liabilities of the parties to such a type of mortgage. Second, the Mortgage Act has granted all approved credit agencies in the country the power of parate execution. (i.e. a creditor can proceed to sell the assets belonging to the debtor without a court order) These credit agencies can enforce their rights of parate execution only if a mortgage is created in the form approved in the schedules to their incorporating statutes. The form which is used to create a mortgage by depositing title deeds differs from the forms that have been approved by the respective statutes establishing the credit agencies and as a result, these credit agencies are hesitant to take security of this nature for fear that their right of parate execution may not be effective.

A conditional transfer of immovable property has become a controversial form of security. A *conditional transfer* is a contract of sale between the borrower and a lender over immovable property subject to a condition that the debtor will have a right to repurchase the property within a stipulated time. In the event of default, the creditor has the right to seize the property and claim its ownership. The key features of a conditional transfer in Sri Lanka and a mortgage by conditional sale in India are the same. Consequently in both countries a question that arose is whether a contract of sale

document is in fact a mortgage bond because it gives the debtor the option to repurchase the property, or whether it is a bill of sale subject to a time constraint. It was seen that the position in India has not been resolved yet, but the Sri Lankan courts have held that a conditional transfer cannot be treated as a mortgage.<sup>49</sup>

The law allows *usufructuary mortgages* to be created over immovable property. A holder of a usufructuary mortgage has the right to take possession of the property only for the purpose of enjoying its profits in lieu of interest due on money lent. The debtor retains the right to redeem the property from the creditor at any time. This form of security is not useful to a lender, consequently, like the lenders in India, Sri Lankan lenders do not accept such security.

*Concurrent mortgage* is where one mortgage bond is executed in favour of two or more persons (each of whom is referred to as "mortgagee") in consideration of sums due or payable to each of such persons by the mortgagor.<sup>50</sup> These mortgages are mainly used as forms of investment and are not important to a lender whose objective is to obtain security for a repayable loan. Hence leading credit institutions do not accept such mortgages.<sup>51</sup>

#### 4.3.2 *Movable Property as Security*

Apart from immovables, movables may also be offered as collateral.<sup>52</sup> Principles of Roman Dutch Law and the Mortgage Act govern the mortgage of movables in Sri Lanka. The law recognises security over movables in the form of a *pledge* or a *mortgage*

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49 Weeramantry, C., *Law of Contracts*, Vol. 2, Mortlake Press, Colombo, 1967, 638-640

50 Section 65(1)

51 *Henry Zoysa v The Jupiter Cigarette Co. Ltd.* (1968) 72 NLR 12

52 Weerasooria W., *Credit and Security in Ceylon (Sri Lanka) : The Legal Problems of*

created by way of registration.<sup>53</sup> A pledge may be validly created when a borrower and a lender enter into an oral agreement to mortgage movable property, and actual delivery of the property is given. The “ostensible” and “bona fide” possession of the property by the mortgagee, is essential for the mortgage to be valid.<sup>54</sup> In the case of *Indian Bank Ltd v Chartered Bank, et al* the Supreme Court while explaining the legal principles governing the mortgage of movable property in Sri Lanka held that the phrase "ostensibly and bona fide in such custody" to mean that possession should be not only bona fide, but be of such a nature as to make it apparent to others that such person was in possession.<sup>55</sup>

A mortgage may be created by way of registration where the property is not actually delivered to the lender. A mortgage can be created by executing a written document by the borrower or by an authorised person to do so, and having the document registered at the office of the Registrar of Lands within 21 days of its execution. Registration of such a document is essential for its validity but it does not confer priority or any other additional right to the parties.<sup>56</sup>

The Mortgage Act sets out a special procedure for the mortgage of shares of a company in favour of "approved credit agencies." The borrower deposits the share certificates with such a credit agency and then executes a document transferring the shares in favour of the agency, or leaves the transferee's name blank. Such a transfer is

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*Development Finance*, University of Queensland, St. Lucia, 1973, Chapters 5 & 6

53 Ibid., Chapter 7

54 Sections 17 & 18, Registration of Documents Ordinance, No 23 of 1927 and Section 18, Prevention of Frauds Ordinance 1840

55 (1941) 43 NLR 49; For a similar view see the *Second Interim Report of the Ceylon Mortgage Commission*, Sessional Paper V, Government Printers, Colombo, 1945, Para 94

56 Section 17, Registration of Documents Ordinance No. 23, 1927

commonly known as “transfer in blank.”<sup>57</sup> As mentioned earlier, in Sri Lanka the mortgage of movables is governed by Roman Dutch Common Law principles and the Mortgage Act, and the law relating to companies is based on English Common Law principles and the Companies Act. As a result, a question that needs to be addressed is which principles govern the mortgage of shares in a company when the special procedure set out in the Mortgage Act does not apply? The Supreme Court in *Mitchell v Fernando*<sup>58</sup> held that Roman Dutch Law applied. Counsel argued that the Civil Law Ordinance required matters relating to Joint Stock Companies to be decided according to English Law and that shares are things not known to Roman Dutch Law, but the judges took the view that this matter was one of mortgage and not an issue in respect of Joint Stock Companies. Although the law provides for the mortgage of shares as security, state lending institutions do not lend on the security of shares. Leading private banks however do lend on such security, provided the shares are of a publicly quoted company.

The Mortgage Act also has special provisions where a mortgagor can mortgage life insurance policies in favour of “approved credit agencies.”<sup>59</sup> Where the mortgagor defaults payment, the approved credit agency has the right to surrender the policy to the insurer and to recover payment of the value of the policy or of such amount that would have been payable to the assured, as if the policy was surrendered by him. A lender that is not an approved credit agency, and who has taken a mortgage over a life insurance policy as security will on the borrower’s default have to obtain a court order to realise the policy. Unfortunately, this cumbersome and expensive procedure of recovery makes

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57 Section 73

58 (1945) 46 NLR 265

lenders very hesitant to lend on the strength of such security.

*Surety Bonds* are commonly accepted because it is considered to be one of the safer categories of collateral. They are also commonly known as *guarantees*, possibly due to the influence of English Laws in Sri Lanka. Although commercial matters are governed by English Common Law principles, the law of suretyship is based on Roman Dutch law principles.<sup>60</sup> The law protects the surety's interests where the principal debtor and creditor are in conflict. For example, the law allows a number of defences to a surety unless he has not expressly renounced them.<sup>61</sup> In practice however, banks and financial institutions do not enter into a contract of suretyship unless the surety expressly renounces all the legal privileges he enjoys. Many state lending institutions are prohibited from taking personal guarantees to secure loans, and are limited to taking immovable property as security. On the other hand, some state banks, most private banks, and other lending institutions do take personal guarantees when granting loans. Invariably, when loans are given to private limited companies the directors are required to guarantee the loans as additional security, and this has been the practice in commercial lending for a long time. In 1968, the Bank of Ceylon Commission observed:

"Ordinarily land should be the most readily available security in any developing country, but the defect of the law in Ceylon lowers its usefulness as a security. This accounts for the fact that in the classification of advances on

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59 Sections 81 & 84

60 Apart from Roman Dutch principles the Prevention Of Frauds Ordinance, No. 7, 1840 also applies. According to Section 18 all contracts of suretyship must be in writing and signed by the surety.

61 Some of the defences are, (a) *Beneficium Ordinis Sec Exclusionis* (i.e. surety to be sued only if the principal debtor is unable to satisfy the judgement debt) (b) *Beneficium Divisionis* (i.e. when several persons are sureties for the same debt the creditor must divide his claim pro rata) (c) *Beneficium Cedendarum Actionum* (i.e. if a surety pays to the creditor the debt due to him he is then entitled to enforce all the rights previously available to the principal creditor).

security, the percentage classified as "other" was increased to a high level of 35.5 per cent of all advances. We understand that the principal form of security categorised under this head is the security of guarantors."<sup>62</sup>

Even today, commercial lenders sometimes lend purely on the creditworthiness of the guarantor, and it would be correct to say that suretyship ranks equally to security taken over immovables.

The Sri Lankan Companies Act 1982 recognises a *floating charge* as a valid charge.<sup>63</sup> Once a floating charge is created, it must be registered with the Registrar of Companies within 21 days of its creation for the purpose of giving notice to other creditors that the company's assets have been charged. If the registration requirement is not satisfied the charge is void against the liquidator, or any creditors that may have a claim. Although the Sri Lankan Companies Act recognises the floating charge very few, if any, such charges have been created. The reason may be ignorance, or fear that the security may prove to be worthless owing to the reluctance of the courts to depart from the Roman Dutch Law which is against extra judicial execution.

Unlike in India, Sri Lanka has legislated for *trust receipts* by enacting the Trust Receipts Ordinance.<sup>64</sup> The Ordinance specifies that trust receipts may be executed only when goods are being imported into the country or exported out of the country.<sup>65</sup> Further, a trust receipt can be executed only by an approved credit agency recognised by the Trust Receipts Ordinance.<sup>66</sup> Consequently, all commercial and state banks that lend on the security of trust receipts have been declared as approved credit agencies by the

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<sup>62</sup> *Report of the Bank of Ceylon Commission*, Sessional Paper XXVII, Vol. I, Government Printer, Colombo, 1968, Para 210

<sup>63</sup> Section 91(1) & (2), Companies Act No. 17 of 1982

<sup>64</sup> No. 12 of 1949. This Ordinance was enacted as a direct result of the recommendations made by the Mortgage Commission of 1945.

<sup>65</sup> Section 2 & 3 respectively



Director of Commerce.

#### 4.4 RANGE OF AVAILABLE SECURITY IN MALAYSIA

There is a wide range of security that lenders may take from borrowers.<sup>67</sup> Malaysian lenders however, favour taking land security,<sup>68</sup> and are no different to lenders in India and Sri Lanka. Compared with the range of security that may be taken over immovable property in India and Sri Lanka, there are only two forms of security over immovable property that may be taken under Malaysian Land law. There are no obvious limitations to creating security.

##### 4.4.1 Security Over Immovable Property

The land law of Malaysia is primarily governed by the National Land Code (hereafter NLC) of 1965, which is fundamentally based on the general structure of the Australian Torrens System.<sup>69</sup> English legal concepts are also reflected in some statutory provisions of the NLC, particularly in dealings and interests in land.<sup>70</sup> In addition, English judgements also influence land law matters. Where land is offered as security the law provides for the creation of two forms of security, namely, a statutory charge and a statutory lien by deposit of title documents and entry of a caveat.<sup>71</sup>

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66 Section 5

67 Pheng, L., *Banking Law*, Butterworths Asia, Malaysia, 1995, Chapter 4

68 Chen Kah Leng, *Country Report For Malaysia*, Paper Presented at the Asian Development Bank Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 16-17

69 Sykes E., and Walker S., *The Law of Securities*, 5th Ed, Law Book Co., Sydney, 1993

70 Wong D., *Tenure and Land Dealings in the Malay States*, Singapore University Press, Singapore, 1975, 158 - 159

71 Sood, T., and Tee, K., *Land Law in Malaysia: Cases and Commentary*, Butterworths, Singapore, 1987, Chapter 7

A *charge* can be created over a whole land as security by executing a formal document for the repayment of any debt and interest.<sup>72</sup> A charge so created will become effective as a security interest only upon due registration.<sup>73</sup> By contrast, it is possible to create a valid but "unregistered charge or equitable charge." However, compared to that of a statutory chargee, the remedies available to an unregistered or equitable chargee is quite limited.<sup>74</sup> A borrower that creates a charge in favour of a bank remains the legal owner of the property, and as a result enjoys the benefits of being vested with the property. As legal title to the property remains with the chargor he has the right to transfer the property subject to the charge to a third party, but the transferee would be bound by the conditions of the charge. He would also have the right to create second and subsequent charges over the land,<sup>75</sup> and may grant a lease, sub lease or exempt tenancy over land with the prior consent of the lender.<sup>76</sup>

A widely discussed issue among writers and judges is whether a charge created under the NLC could be distinguished from a mortgage at Common Law, or whether such a statutory charge could in fact be considered in the general nature of an English mortgage. Briefly, the argument distinguishing the two is that, in an English Common Law mortgage, the title to the property is transferred to the mortgagee with a proviso for redemption, whereas in a torrens mortgage, legal title to the property remains with the chargor.<sup>77</sup> On the other hand, some argue that although there is a fundamental

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72 Section 241(1) NLC

73 Section 243

74 *Oriental Bank v Chup Seng Restaurant and Butterworth Sdn Bhd*. [1990] 3 MLJ 493 at 495 per Mohamed Dzaidan J

75 Section 241

76 Sections 215(3) and 216(1)

77 *Bank Bhumiputra Malaysia Bhd v Doric Development Sdn Bhd and Ors* [1988] 1 MLJ 462- 463

difference between the two securities the torrens mortgage has many features of an English Common Law mortgage as a security device.<sup>78</sup> When a charge is created under the torrens system, it does not involve the transfer of the legal ownership of the land from the chargor to the chargee, and the chargor remains in possession of the property.<sup>79</sup>

Sir Samuel Thomas CJ observed,

“[a] charge is a very different transaction to a mortgage. There is no such thing as a mortgage of land known to the law of the Federated Malay States. Charges alone are recognised. The rights arising from a charge are contained in the Land Code. It is not possible to seek to introduce the elements of an English mortgage into a charge as provided by the law of the Federated Malay States.”<sup>80</sup>

On the other hand, the Malaysian courts often resort to English principles for guidance in the interpretation of statutory provisions particularly, if the legislation is silent on an issue.

The second form of security that lenders accept is a *statutory lien* that is created in its favour over land or a lease owned by the borrower. A statutory lien may be created by an owner or lessee by depositing with the lenders his original document of title to the land, or in the case of a lease a duplicate copy as security for a loan. The lender will then apply to the land registry for the entry of a lien-holder's caveat, and upon the caveat being entered it will become entitled to a lien over the land or lease.<sup>81</sup> Once a lien holder's caveat is entered, the owner of the land is precluded from registering any dealings with regard to that property without the prior consent of the lien holder.<sup>82</sup>

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78 Wong D., *Tenure and Land Dealings in the Malay States*, Singapore University Press, Singapore, 1975, 173-174

79 *E.S. and A. Bank v Philip* (1937) 57 CLR 302 at 321

80 *Gan Khor v Soan Bin Pelita* [1935] 4 MLJ 158 per Sir Samuel Thomas CJ

81 Section 281

82 Sections 322(3) and 350(5)

To create a valid statutory lien under the NLC the deposit of title documents with the lender alone is not adequate, because the formality of registering the lien holder's caveat is also an essential part of the process. The nature of the statutory lien created under section 281 of the NLC has been debated in the Malaysian Courts. In *Zeno Ltd v Prefabricated Construction Company (Malaysia) Ltd.*, Rajah Azlan Shah J ruled that the lien holder's interest is "an equitable interest in the land capable of being caveated."<sup>83</sup> On appeal the court ruled that a lien is a separate legal-statutory lien, and that it has an independent existence apart from a charge. Therefore, if a charge is avoided for non-compliance with the law, the lien is not avoided, provided it complies with the law.<sup>84</sup>

*Jual Janji* transaction is another form of security used in Malaysia. It is a kind of Malay customary dealing with land. It evolved as a customary security transaction because under Islamic Law, a Muslim is prohibited from accepting or paying interest on any loan he takes or borrows. Since the majority of Malay peasants are Muslim they will not pay interest under a normal loan agreement. The majority of *Jual Janji* transactions are entered into by peasant borrowers to raise money for cultivation, usually "*padi*" (paddy) in rural areas. The borrower "transfers - to use the word in a loose sense - his land to the lender who thereby takes possession of it. Whatever profits the lender may make out of the land will be his to keep as a reward, akin to interest for the loan. The borrower is entitled to resume the land upon discharging the debt except that, where a period was fixed for the repayment of the loan default will turn the

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83 [1967] 2 MLJ 104, 107

84 *Paramoo v Zeno Ltd* [1968] 2 MLJ 230

original, arrangement into an absolute sale, *jual putus*.”<sup>85</sup>

After the torrens system of land dealings was adopted in Malaysia, *Jual Janji* transactions were not given any recognition. Consequently, it changed its form where the borrower transferred the title of the land to the lender, subject to an agreement that it will be re-transferred to the borrower upon the debt being settled in full within the stipulated period. This transformed the original *Jual Janji* customary security transaction into a form of security akin to an English mortgage at common law. They are now used by non-Muslim borrowers as well.

#### 4.4.1 Security Over Movable

*Pledge* is a form of security that is widely used by Malaysian lenders.<sup>86</sup> The law governing the pledge is found in the Contracts Act 1950 and the Sale of Goods (Malay States) Ordinance 1957.<sup>87</sup> A pledge is defined as a bailment of the goods as security, for the payment of a debt or performance of a promise.<sup>88</sup> The law recognises the actual delivery of goods or constructive delivery,<sup>89</sup> for example by handing over the key to the warehouse in which the goods are kept.<sup>90</sup> A question that would arise is whether a pledge of documents means that it is in fact a pledge of goods represented by the

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85 Wong S., *Jual Janji Transactions - A Question of Recognition and Equitable Intervention* (1973) 15 Mal LR 27

86 Sing, J., *Credit and Security in West Malaysia*, University of Queensland Press, St. Lucia, 1980, 216-224

87 The Contracts Act 1950 is identical in most material aspects to the Indian Contracts Act 1872 and the Indian statute, which in turn was based on the English statutes.

88 Sections 124 & 125, Contracts Act, 1950

89 Section 101 & 102, Contracts Act, 1950

90 In addition to Malaysia, key loan systems are operated in Indonesia and Singapore. Allan, D., et al, *Credit and Security : Economic Orders and Legal Regimes* (1984) 33 ICLQ 22, 80

documents, or whether the pledge applies only to the documents.<sup>91</sup> In the United Kingdom, the Factors Act 1889 recognises the pledging of title documents to goods as a pledge of the goods relating to the transactions covered by that Act.<sup>92</sup> Malaysia does not have a Factors Act but provisions of the English statute could be applied in Malaysia by applying the Civil Law Act of 1956 (Revised 1972). This would mean that under Malaysian law a valid pledge of the goods themselves could be created by pledging the documents of title to the goods.<sup>93</sup>

Malaysian lenders often take floating charges created over debtor companies movable assets present and future, and considers it as an effective form of security.<sup>94</sup> As in India and Sri Lanka, the Malaysian Companies Act states that a floating charge created by a company is void against a liquidator or any creditor of the company unless it is registered with the Registrar of Companies. Registration must be carried out within 30 days of its creation.<sup>95</sup>

*Trust receipts* are widely used by bankers when loans are granted to borrowers for the purpose of importing and exporting goods<sup>96</sup> The law governing trust receipts in Malaysia is far from settled. In fact there is no legislation which has been enacted to deal with the subject. The law that governs trust receipts is the law applicable to pledges, i.e. the Contracts Act, 1950 and the English Factor's Act, 1889.

Lenders in Malaysia readily accept *personal guarantees* when granting credit

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91 Section 101 & 102 of the Contracts Act, 1950

92 Section 2

93 *Chan Cheng Kum v Wah Tat Bank Ltd.* [1971] MLJ 177

94 Interviews with Chan Yim Fun and Lim San Peen, Executive Directors, Price-Waterhouse, Malaysia, Kuala Lumpur, on 29 May 1997.

95 Section 108

96 Yok, J, and Savarimuttu, N.G., *Banking in Malaysia*, Longman Malaysia, Selangor, 1987, 106

facilities, particularly to small and medium scale businesses. Personal guarantees are normally taken in addition to taking real security from borrowers. In the case of corporate lending, banks would normally require the directors or shareholders of the company to guarantee the credit facilities so that the guarantors are responsible for the profitable running of the enterprise which would ensure repayment of its debts. In the case of loans to larger businesses the size and reputation of the enterprise is considered adequate security. The law governing guarantees is the same as in India. In both countries the respective Contract Acts contain the statutory provisions which are identical in all material aspects.<sup>97</sup>

The Malaysian Contracts Act defines a contract of guarantee as "a contract to perform the promise or discharge the liability of a third person in the case of default. Such a contract can be either oral or written, and must be supported by consideration. A guarantor's liability to the lender co-exists with that of the principal debtor and also to the same extent as the borrower<sup>98</sup> unless a limitation has been placed in the guarantee. Further in the case of default, a lender has the right to proceed against a guarantor without first exhausting all its remedies against the principal debtor. In *Kwong Yik Finance Bhd v Mutual Endeavour Sdn Bhd & Or* the plaintiff sought to recover the money from the debtor as well as the guarantors, the 2nd and 3rd defendants. The guarantors contended that they were liable to pay the plaintiff only if there was a shortfall of the debt owing, and that recovery proceedings must first be filed against the principal debtor. The Court held that,

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97 For Malaysia, see sections 77-100 in Part VIII of the Contracts Act of 1950. For India, the identical statutory sections are seen in sections 124-147 of the Indian Contracts Act 1872

98 Sections 81

“Just as the guarantors have no right to demand that the plaintiff creditor calls upon the first defendant as the principal debtor, to settle the debt before asking them, the guarantors, to pay, they too have no right to insist that the plaintiff set off the charged property just to off set the debt before suing them on the guarantee. The plaintiff had the option to exercise which of two securities it wished to enforce. It may even enforce both securities, as is done in this case, if it is found that one security is insufficient to settle the debt and it was to meet this eventuality that the plaintiff had in its wisdom insisted upon two forms of security, the charge as well as the guarantee.”<sup>99</sup>

#### 4.5 *ENFORCEMENT OF SECURITY IN INDIA*

Security is truly effective only to the extent that it may be enforced both quickly and cheaply for the purpose of recovering the underlying debt which is due, and where there are competing claims against an insolvent debtor, to gain priority over other unsecured creditors. If enforcement of security is time consuming and expensive, valuable funds of lending institutions will be held up from being used for other creditworthy purposes. Enforcement is therefore an important aspect of security which must be considered.

In India, enforcing security is not easy. There are a number of legal as well as practical problems that hamper effective enforcement of security. A significant difficulty faced by Indian lenders is that the law does not freely provide for self-help remedies. The majority of Indian judges are also reluctant to allow extra-judicial enforcement procedures. The concerns of the Indian judges were well explained by Krishnaswamy Naidu J when he said,

“While the power of sale without the intervention of court may be supported and justified in the conditions prevailing in a commercially advanced country like England, where the machinery employed for selling the properties can be said to be perfect and reliable its introduction in India, .....does not seem to be necessary or justified since from the result of its working it has been found that there is scope for its abuse resulting in great injustice to bonafide mortgagors

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99 [1989] MLJ 135, 136



who are likely to be deprived of their properties by an improper and irregular exercise of the power of sale.”<sup>100</sup>

#### 4.5.1 *Enforcement of Mortgage Security Under the Transfer of Property Act, 1882*

The enforcement of a mortgage security is governed by section 67 of the Transfer of Property Act. In the absence of a contract to the contrary, a bank as a mortgagee has the right, at any time after the loan becomes due, to obtain from court a decree for the sale of the property that was mortgaged, or a decree for foreclosure. Once a decree for foreclosure has been obtained the mortgagor is absolutely debarred of his right to redeem the mortgaged property. Prior to 1929 the remedy of foreclosure was available to mortgagees with conditional sales and English mortgages but Rule 4(2) of Order 34 of the Civil Procedure Code empowered the Indian courts to direct a sale in lieu of foreclosure. The result was that courts in various parts of the country exercised their discretion differently. For example, the trend in the courts in Calcutta and Alahabad was to refuse foreclosure, while in Bombay foreclosure decrees were granted.<sup>101</sup> In 1929, section 67 was amended by section 31 of the Transfer of Property (Amendment) Act of that year.

Section 67(a) (as amended) provides, amongst others, that:

"...Nothing in this section shall be deemed-

(a) to authorise any mortgagee other than a mortgagee by conditional sale or a mortgagee under an anomalous mortgage by the terms of which he is entitled to foreclose, to institute a suit for foreclosure, or an usufructuary mortgagee as such or a mortgagee by conditional sale as such to institute a suit for sale; or..."

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<sup>100</sup> *A. Batcha Saheb v Nariman K. Irani* [1955] AIR (Mad) 491, 493

<sup>101</sup> See the observations of the Report of the Special Committee of 1929 on the changes required to Section 67 in TP Act reported in Chitaley D., Appu Rao, S., *A.I.R. Commentaries, The Transfer of Property Act (No.4 of 1882)* 4th Ed., Vol. 11, All India Reporter Ltd., Nagpur, 1969, 1277

According to the first part of clause 67(a) a mortgagee by conditional sale has a right of foreclosure but the latter part prohibits filing a suit for a decree of sale. In other words leaving only the remedy of foreclosure available to a mortgagee by conditional sale.<sup>102</sup> A usufructuary mortgagee cannot sue for a decree of sale or foreclosure. The remedy is possession of the mortgaged property. A lender that takes mortgaged security by accepting a deposit of title deeds can enforce its security only by way of sale.<sup>103</sup> A lender with a simple mortgage can obtain only a decree for sale but not for foreclosure.<sup>104</sup> In the case of anomalous mortgagees the enforcement rights will solely depend on the terms and conditions governing the mortgage. Clause 67(a) allows such a mortgagee to file for a decree of foreclosure and does not prohibit him from filing suit for a decree of sale if the mortgage agreement does not bar such an action.<sup>105</sup>

It is obvious that section 67 lacks clarity. The remedies available to mortgagees that have taken different forms of mortgages need to be simply restated, rather than having to work out what the law is intending to communicate. In 1977 the Law Commission of India recommended that section 67 should be redrafted, and that the right to bring action for foreclosure should be removed from the statute.<sup>106</sup> This recommendation was not implemented by the Government in office.

A mortgagee with an English mortgage can enforce its security by first obtaining a decree for sale of the property but it cannot file suit for a decree of

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102 *Vala Punja & Ors v Puna Mavji & Another* [1963] AIR (Guj) 112, 115

103 *Ramazan Yegi & Another v Messrs Balthaza & Son Ltd* [1936] AIR (Rang) 290, 292

104 *Chandramma v Gunasethan* [1931] AIR (Mad) 542

105 *Savitri Devi v Beni Devi & Others* [1968] AIR (Pat) 222, 225

106 *70th Report of Law Commission of India on The Transfer of Property Act, 1882*, Sadar Patel Marg, Allahabad, 1977, 472

foreclosure.<sup>107</sup> In addition to having a right of sale by obtaining a court order, in very limited circumstances, a mortgagee would have the right of extra judicial sale under section 69 of the Act. A bank or lending institution which has taken an English mortgage is also entitled to appoint a receiver of income of the mortgaged property or any part thereof.<sup>108</sup> The lender also has authority to apply to court for the appointment of a receiver, if the person appointed by the deed is not in a position to act as a receiver. Such an appointed receiver will be deemed to have been appointed by the mortgagee.<sup>109</sup>

A receiver appointed under an English mortgage is the agent of the mortgagor unless the mortgage instrument provides to the contrary. Consequently, the mortgagor is solely responsible for the receiver's acts unless such acts are caused by the improper intervention of the mortgagee. The powers and duties of a private receiver are set out in sections 69A (3)-(8), and these statutory provisions are identical in all material particulars to section 109 of the English Law of Property Act.<sup>110</sup> Conversely, the Civil Procedure Code also empowers mortgagees to have receivers appointed by court under Order 40 Rule 1 which gives a court receiver a range of powers.

#### *Power of Extra-Judicial Sale*

The mortgagee that has taken an English mortgage has the right to sell the mortgaged property without first obtaining a court order. This right of extra-judicial enforcement may be used in the following situations:

Section 69(1) provides:

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107 *Mukherjee v Agrawalla* [1968] AIR (Cal) 153

108 Section 69(a)(i)

109 Section 69(a)(ii)

110 Chitale D., and Appu Rao S., *A.I.R. Commentaries : The Transfer of Property Act (No.4 of 1882)* 4<sup>th</sup> Ed., Vol. 11, All India Reporter Ltd., Nagpur, 1969, 1359

- “(a) where the mortgage is an English Mortgage, and neither the mortgagor nor the mortgagee is a Hindu, Muhammedam or Buddhist or a member of any other race, sect tribe or class from time to time specified in this behalf by the State Government in the Official Gazette;
- (b) where a power of sale without the intervention of the Court is expressly conferred on the mortgagee by the mortgage deed and the mortgagee is the government;
- (c) where a power of sale without the intervention of the court is expressly conferred on the mortgagee by the mortgage deed and the mortgaged property or any part thereof was, on the date of the execution of the mortgage deed, situate within the towns of Calcutta, Madras, Bombay or in any other town or area which the State Government may, by notification in the Official Gazette, specify in this behalf.”

The law allows the right of private sale only in extremely limited situations. In 1977 the Banking Laws Committee observed that this approach was clearly right for an era where the principal providers of credit were private moneylenders, and went on to recommend that the law should be amended to give the right of private sale to banks and certain public financing institutions, because they are now the providers of credit for productive development purposes.<sup>111</sup> The Committee was of the view that if the right of private sale is withheld from these lenders it would adversely affect the flow of credit, and hinder expeditious debt recovery due to unnecessary delays and high litigation expenses. The Committee recommended that the application of this law should be modified and suggested that,

“The power of sale without the intervention of court should be allowed to all banks and certain notified financing institutions and this should be available to them with reference to all types of advances other than those made against the security of agricultural land and should be available independent of the form of the mortgage in their favour.”<sup>112</sup>

This recommendation has not been given effect to.

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<sup>111</sup> *Report of The Banking Laws Committee on Real Property Security Law*, Government of India, Delhi, 1977, 31

<sup>112</sup> *Report on Real Property Security Law*, Government of India, Delhi, 1977, 34

#### 4.5.2 *Enforcement Of Rights Under a Pledge or Hypothecation*

Where goods are pledged to a lender and the borrower defaults payment, the lender has two alternate remedies open to it. A lender may file action for the payment of money and retain the pledged goods as security or he may, after giving the pledgor reasonable notice sell the pledged property without a court order.<sup>113</sup> Once the sale is completed the proceeds must be used to satisfy the outstanding debt and any excess must be repaid to the borrower. Lenders that have entered into "key loan arrangements" also have the power to sell the property without court intervention.<sup>114</sup>

Unlike in a pledge, a lender's right with regard to goods hypothecated to it is not clearly stated in any Indian statute. Lenders therefore insist on including a specific clause in the hypothecation agreement which gives them the power to take possession and sell the secured property without a court order. The effectiveness of inserting such clauses has been argued in a number cases, and judicial opinion is diverse. Some courts have ruled that a hypothecation agreement is entirely regulated by the terms of the contract between the parties and upon default, a lender can exercise his right of possession and sale without a court order. In *Bank of Maharashtra v Official Liquidator*, Narayana Pai J said

"Hypothecation is only an extended idea of a pledge, the creditor permitting the debtor to retain possession either on behalf of or in trust for himself. (the creditor) Hence so far as the movables actually covered by hypothecation deeds are concerned, there can be no doubt that the bank is entitled to retain possession and also exercise the right of private sale."<sup>115</sup>

By contrast, other courts have ruled that a hypothecation agreement creates only an

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113 Section 176, Contracts Act, 1950; See Abichandani, R., (Ed) *Pollock and Mulla on Indian Contract and Specific Relief Acts*, 11th Ed., Vol. 11, N.M. Tripathi Private Ltd., 1994, 1059-1061

114 *Bank Of Maharashtra v Official Liquidator* (1969) AIR (Mys) 280

115 [1969] AIR (Mys) 280, at 287

equitable right in favour of the hypothecatee, and that such rights can be enforced only after obtaining a court order. A particularly strong case is *Bank of India v S.B. Shah Ali* where a hypothecation agreement between the parties specifically gave the Bank of India the power to take possession, appoint receivers and to sell a lorry by public auction or private sale. Upon default, the Bank took possession and sold the lorry without obtaining a court order. The Court held that the bank was not entitled to take possession or sell the property without an order from the Court. In so holding the Court explained:

"[W]hen the hypothecation creates only a charge, it is only a right in respect of the property and such a covenant in the contract can only be enforced through court. The reason being that in the absence of *de jure* or *de facto* possession or transfer of title, a person cannot take the law into his own hands and take possession of the goods forcibly when the debtor obstructs taking possession."<sup>116</sup>

#### 4.5.3 *Receivership Under the Companies Act, 1956*

Indian law recognises the creation of a floating charge by a company in favour of a debenture holder as a means of security for money lent to it.<sup>117</sup> If a borrower defaults repayment a debenture holder may, if authorised to do so by the debenture, appoint a receiver. Failing such authority in the debenture the bank may apply to court for an order to have a receiver appointed.<sup>118</sup> Notice of a receiver's appointment must be given to the Registrar of Companies within thirty days of the appointment, who will in turn, enter it in the Register of Charges. The sanction for non-compliance is a fine.<sup>119</sup> Further, a bank may appoint a manager to the charged property under the terms of the

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116 [1987] 2 Andhra Law Times Report 470, at 476

117 Singh, A., *Company Law*, 9th Ed., Eastern Law Book Co., Lucknow, 1989, 351

118 Section 137(1) Companies Act, 1956

119 Section 137(2) Companies Act, 1956

debenture, or have a manager appointed by court.<sup>120</sup> All the statutory provisions relating to a receiver also apply to a manager.<sup>121</sup> To a lender, the most important point about taking a floating charge as security is that it has the power to appoint a receiver or manager without recourse to court. Although the law clearly provides for extra-judicial appointments, Indian banks still prefer to have receivers appointed by court under Order 40 Rule 1 of the Civil Procedure Code.<sup>122</sup> This is rather surprising because the delays experienced in the Indian courts are widely known, and a right which enables a lender to enforce its security privately can be very useful.

#### 4.6 *ENFORCEMENT OF SECURITY IN SRI LANKA*

The legal handicaps faced by Sri Lankan lenders trying to enforce security were recognised as far back as in 1934. The differing views expressed by the various commissions of inquiry as to the changes that should be made to the law, left the problem unresolved for over fifty years. In 1934, the Banking Commission observed that banks and other commercial bodies repeatedly made representations to the government in office complaining that "the Judiciary had to be frequently approached to enforce the rights of creditors", and that the commercial laws of Ceylon did not help the creditors.<sup>123</sup> No steps were taken to address this deficiency. Later, the Mortgage Commission of 1945 disagreed with the recommendations made by the Banking Commission. It was particularly opposed to the Banking Commission's

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120 Section 424, Companies Act, 1956

121 Singh, A., *Company Law*, 9th Ed., Eastern Law Book Co., Lucknow, 1989, 357

122 Pillai, P., & Nair, P., *Law of Receivers*, 3rd Ed., Law Book Company, Allahabad, 1988, 818-822

123 *Report of the Ceylon Banking Commission*, Sessional Paper XXII, Vol. 1, Government Printers, Colombo, 1934, Para. 426

recommendation that banks must be given extra-judicial enforcement powers. The Mortgage Commission concluded that, what ever the provisions may be in English law so far as Ceylon is concerned, it is unhesitatingly of the opinion that it would be most unwise to confer the right of parate execution over land.<sup>124</sup>

The Wimalaratne Committee of 1985 recommended that parate execution in relation to corporeal movables should be extended to more lending institutions. There was strong opposition to the suggested changes by the Bar Association of Sri Lanka, and as a result implementation of these recommendations were deferred.<sup>125</sup> Meanwhile, the World Bank and the Asian Development Bank also indicated that the laws in the country must be suitably amended to facilitate expeditious debt recovery. Eventually, however, significant change in the law of credit and security in Sri Lanka occurred in early 1990, when the Cabinet approved the enactment of fourteen statutes as one package relating to debt recovery. The enforcement of security without court intervention is now governed by the Recovery of Loans By Banks (Special Provisions) Act, 1990.

#### 4.6.1 *Parate Execution Under the Recovery Of Loans By Banks (Special Provisions) Act, 1990*

The Recovery of Loans By Banks (Special Provisions) Act gives the right of parate execution to all commercial banks, and extends this right in respect of both immovable and movable property. When a borrower defaults in payment, the board of directors of a bank has the power to authorise the sale of the property mortgaged to it by

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124 *Second Interim Report of the Mortgage Commission, Sessional Paper V, Government Printers, Colombo, 1945 Para 94-95*

125 *Third Report of the Presidential Commission On Finance and Banking on Debt*



public auction to recover its debts.<sup>126</sup> If however, payment is made to the bank before the date for the auction is fixed, no further steps may be taken by the bank.<sup>127</sup> The Board also has the power to authorise any person to take possession of the property mortgaged to the bank. Such a person appointed by the Board of Directors has all the rights and powers of a receiver appointed under the Mortgage Act.<sup>128</sup> When the outstanding debts have been fully recovered, the Board must surrender possession of the mortgaged property to the borrower.<sup>129</sup>

So far, lenders have been extremely reluctant to exercise their statutory rights of parate execution, possibly in the past because the courts have viewed this remedy as deplorable and harsh. For example, in the case of *Mendis v The Ceylon State Mortgage Bank* which arose under the Mortgage Act of 1949, the Bank sold the property by auction to a sole bidder for almost half its market value. The court decided that the bank did not commit a breach of any legal duty by selling the property, and that in the absence of any negligence in the conduct of the sale the bank was not liable for the loss suffered by the appellant. But both judges were critical of the fact that a legislative measure intended to benefit the subject had in its operation produced a result which, though not illegal, was “revolting to ones sense of justice and fair play.”<sup>130</sup> Basnayake CJ, observed:

"The plaintiff has suffered a cruel fate at the hands of the State lending institution whose aid he sought. No private moneylender would have been permitted by the courts to act in the way the defendant bank had done. This case

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*Recovery Legislation*, Department of Government Printing, Colombo, 1992, 1

126 Section 4

127 Section 10

128 Section 5

129 Section 5(3)

130 (1959) 61 NLR 385, 382

should serve as a warning to the legislature against entrusting vast powers to State agencies without adequate safeguards."<sup>131</sup>

#### 4.6 2 *Enforcement Of Mortgage Security Under The Mortgage Act, 1949*

The law and procedure under which a mortgagee can realise its security is contained in the Mortgage Act of 1949.<sup>132</sup> The provisions of this Act reflect principles of Roman Dutch Law.

##### *Power of Sale*

A lender that has taken immovable property as security, can sue the debtor to enforce payment, whether or not the mortgagor is in possession of the mortgaged property at the time of action.<sup>133</sup> Where a court concludes that the mortgage ought to be enforced, it must make an order for the mortgaged property to be sold. The law prohibits the sale of any other property of the mortgagee other than the mortgaged property which the lender has taken as security for the recovery of any money found to be due under the mortgage.<sup>134</sup> If however, if a loan exceeds Rs.150,000/- a lender taking a mortgaged security has the right to call upon the borrower to renounce the benefit afforded to it under the Act.<sup>135</sup>

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131 Ibid., at 386

132 *Legislative Enactments of the Democratic Socialist Republic of Sri Lanka, 1980*, (Revised Edition) Chapter 98

133 Section 7

134 Section 46

135 Section 47A as amended by the Mortgage (Amendment) Act, No. 3 of 1990. In 1945, the Mortgage Commission, while recommending the enactment of Sections. 46 and 47 of the Act of 1949, stated that provision must be made for express renunciation of this right by way of a separate instrument attested by a Notary. (*Second Interim Report of the Mortgage Commission*, Sessional Paper V, 1945, Para. 117.) The government in office at the time did not accept this recommendation, but in 1990, after the lapse of forty-five years the law was amended.

Where a lender has taken movable property as mortgage security, and the borrower defaults, the Mortgage Act allows an action to be instituted to obtain an order from court for the sale of the movable property. If movable property has been mortgaged to an approved credit agency, the Act allows such an agency to sell by public auction any of the property subject to a mortgage without first obtaining an order from court.<sup>136</sup> If the money realised is in excess of the amount due to the agency the mortgagor is entitled to the balance after satisfying the debt, but if the money realised is insufficient, the agency will have to sue for the balance under the normal recovery procedures of the country.<sup>137</sup>

### *Receivership*

The Mortgage Act allows a mortgagee of land to make an application to court for the appointment of a receiver in respect of the land which is mortgaged to it.<sup>138</sup> A receiver so appointed would have all the rights and powers of the owner of the land for its management, protection, and preservation and for the collection of rents and profits accruing from the property.<sup>139</sup> The receiver has a duty to court to submit accounts, to make payments into court from the rents and profits received, and must be responsible for any damage caused to the land or loss incurred by his negligence, or any intentional act of omission.<sup>140</sup>

A mortgagee of movable property also has the right to make an application to court for the appointment of a receiver. However such an application may be made only

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136 Section 85

137 Section 87

138 Section 37(1)

139 Section 41(1)

140 Section 42

if the mortgage is created in respect of the entirety of the goods which include existing as well as future stock in trade.<sup>141</sup>

#### 4.6.3 *Receivership Under The Companies Act, 1982*

The Sri Lankan Companies Act recognises a debenture holder's right to appoint a receiver and manager of the property if such a power is conferred by the debenture. The Act provides for the appointment of a receiver and manager by obtaining an order from court, or where the debenture provides for it without recourse to court.<sup>142</sup> Once a receiver or manager is appointed he is under a duty to inform the Registrar of Companies of his appointment within 7 days, and the Registrar, in turn, must enter the fact in the Register of Charges.<sup>143</sup> A receiver who does not comply with these requirements is guilty of an offence and is liable to a fine.<sup>144</sup> Although the law provides for the appointment of a receiver under a debenture, in practice, hardly any appear to have been appointed by lenders.

#### 4.7 *ENFORCEMENT OF SECURITY IN MALAYSIA*

Malaysian law recognises judicial as well as private enforcement procedures. Compared with India and Sri Lanka, lenders are not hesitant to exercise their extra-judicial enforcement rights and have them carried out by qualified insolvency practitioners.<sup>145</sup> The relative efficiency of the judicial process in Malaysia, compared

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141 Section 96

142 Section 382

143 Section 98(1)

144 Section 98(2)

145 Interviews with Mr. Lim San Peen and Mrs Chan Yim Fun, Executive Directors, Price Waterhouse Malaysia, Kuala Lumpur, on 29 May 1997.

with India and Sri Lanka, is a factor.

#### 4.7.1 *Enforcement of Real Property Security Under the National Land Code, 1950*

Where a lender has taken a statutory charge as security under the National Land Code (NLC) and the borrower defaults in repayment, the NLC provides the chargee with two remedies namely, judicial sale and, in limited circumstances, possession.<sup>146</sup>

##### *Judicial Sale*

The National Land Code has two different procedures for the sale of charged property created under the Code.<sup>147</sup> In both instances the chargee must serve notice on the chargor in the prescribed form identifying the breach, and requiring it to be remedied within one month or such time as may be specified in the charge. Warning should be given that proceedings will be commenced to obtain an order for sale of the property in the event of a continued failure to remedy the breach.<sup>148</sup> If payment is not made and the land or the lease is held under registry title<sup>149</sup> an application could be made to the High Court for an order to sell the charged property.<sup>150</sup> An order will normally be granted unless the court is satisfied of the existence of "cause to the contrary."<sup>151</sup> The order will specify that the sale must be by public auction under the direction of an

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146 Section 253

147 Fatt, W., & Lieng, C., *Chargee's Remedies & Chargor's Rights Under the NLC* [1990] 3 MLJ xcvi

148 Section 254

149 According to section 5 of the NLC, "registry title" means title evidenced by a grant or state lease or by any document of title registered under the provisions of any previous land law.

150 Order 83 of the Rules of the High Court

156 *Perwira Habib Bank Malaysia Bhd v Oon Seng Development Sdn Bhd* (1990) 1 MLJ 447

officer of the court and not less than one month from the date of the order.<sup>152</sup> Where there have been no bidders at the public auction the court has allowed the sale of property by private treaty.<sup>153</sup>

If the charged land is held under a “land office title” an application for sale can be made to the Land Administrator (formerly known as the Collector of Land Revenue).<sup>154</sup> The Land Administrator shall hold an enquiry and give an opportunity to the chargor to show cause why the order for sale should not be made. The Land Administrator will make an order for sale unless there is good cause or reason to the contrary.

A lender that has taken a statutory lien over land may enforce the security by first proving the outstanding debt in court, obtaining judgement in his favour and thereafter applying to court for an order of sale.<sup>155</sup> The procedure to follow for an order for sale is the same as when a registered charge is enforced. Once an order for sale is obtained, it is carried out by public auction. After the auction has been completed the sale proceeds must be deposited in a special account in a government department. The procedure to retrieve the money from the account is reported to be bureaucratic and takes up to one year or more.<sup>156</sup>

### *Possession*

A chargee could also take possession of the property over which it has a

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152 Section 257 & 259 NLC

153 *Malaysian United Bank v Cheah Kim Yu (Beh Sai Ming & Satu Lain Pencelah)* [1991] 1 MLJ 313

154 Section 260 NLC

155 Section 281(2) NLC

156 Interview with Mr. Ismail, Senior Practising Lawyer, Mohamed Ismail & Co, Kuala Lumpur, on 30 May 1997.

charge. It would then be able to receive either rents or profits which would otherwise be payable to the chargor by its tenants, or if the property is not subject to a lease or tenancy by taking actual possession of it.<sup>157</sup> This however, is a remedy seldom used by lenders in Malaysia who prefer to exercise their rights of judicial sale. At least two reasons could be given. First, if the property is occupied by the chargor or his tenants, a chargee bank cannot take actual possession without serving prior notice of its intention to do so.<sup>158</sup> Second, the chargee bank would be accountable to the chargor not only for what it receives whilst being in possession of the property but also for any additional income it should have received by the prudent exercise of its powers.<sup>159</sup>

The enforcement of a charge or lien created under the NLC requires judicial intervention. A practice has therefore evolved where clauses are inserted into security documents giving lenders the power of sale by private treaty without making the required application to court. This practice has received judicial approval in certain cases.<sup>160</sup> The position is however far from resolved as some judges have refused to uphold the validity of private sales.<sup>161</sup>

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157 Section 271 NLC

158 Section 272 NLC

159 Section 274 NLC

160 *United Malayan Banking Corp Bhd v Official Receiver and Liquidator of Soon Hup Seng Sdn Bhd (In Liquidation) & Another* [1986] 1 MLJ 75 (HC); The case was criticised for undermining the purpose of The National Land Code in Puthuchery, J., & Nadkarni, N., *UMBC v Soon Hup Seng: Deathknell for Chargor Protection* [1987] 2 MLJ cxlvii

161 *In Re Sama Corp Sdn Bhd; CI Holdings Bhd v Fabatan Pemegang Harta* [1992] 2 MLJ 251. See also Cheang, L., & Chiew, A., *A Legal Impossibility : Arming Chargees With Private Power of Sale of Charged Land Outside the Provisions of the National Land Code, 1965* [1990] 1 MLJ xxxvi

#### 4.7.2 *Enforcement of a Pledge*

If a pledgor defaults in payment within the stipulated time the pledgee may either sue for payment and retain the goods until payment is made, or sell the pledged goods after giving the pledgor reasonable notice.<sup>162</sup> If the proceeds of such a sale are not adequate to repay the amount due, the borrower will continue to be liable to the lender to pay the outstanding balance. If however, the sale proceeds are greater than the outstanding debt the lender must return the surplus to the borrower.<sup>163</sup>

#### 4.7.3 *Appointing a Receiver Under the Companies Act, 1965*

The enforcement of a debenture that has created a fixed or floating charge or both, over a debtor's property is by the appointment of a receiver to realise the assets subject to the charge in favour of the debenture holder.<sup>164</sup> A receiver and manager may be appointed either by court, or by the debenture holder if such a right has been conferred upon it by the debenture. In practice, lenders often appoint receivers privately because they consider the judicial process to be too slow.<sup>165</sup> The powers of a receiver appointed by a debenture holder are derived from the debenture deed.<sup>166</sup> The duties of a receiver however, are outlined in the Act.<sup>167</sup> The primary duty of the receiver is to realise the secured assets and discharge the liabilities of the debtor in the proper order of

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162 Section 129, Contracts Act, 1950

163 Ibid.

164 Kamar, S., *Powers of Receiver and Manager* [1995] 3 MLJ 229

165 Interview With Mr. Lim San Peen, Executive Director, Price Waterhouse Malaysia, Kuala Lumpur, on 29 May 1997

166 In the Malaysian High Court case *Tan Ah Teck (t/a Plumcon Plumbing Construction Co) v Coffral (Malaysia) Sdn Bhd*, Wan Yahya J said,

“...a debenture holder's receiver is only empowered to act and do all things which he is authorised according to the debenture and the covering trust deed which provide for his appointment.” [1992] 1 MLJ 553, 558



priorities. Expenses of receivership are considered pre preferential debts and employee dues are considered preferential debts. Both these debts have priority over a floating charge holder's claim.<sup>168</sup> A receiver therefore has a statutory obligation to pay these debts before settling the debts of the debenture holder.

#### 4.8 *PROBLEMS OF ENFORCING SECURITY*

Banks and other lending institutions in India, Sri Lanka and Malaysia may follow a number of procedures judicial and otherwise to enforce their security rights. Lenders in India and Sri Lanka are particularly concerned as to the poor results achieved by them when the available enforcement mechanisms are used. A recent decision given by the Federal Court of Malaysia also raises the question whether judicial attitudes are changing in favour of debtors. Broadly speaking, the basis of the problem may lie in the "credit culture" in these countries. In other words, whether the laws and judicial attitudes in these countries are pro-creditor or pro-debtor. Let us examine some of the relevant laws.

##### 4.8.1 *Industrial Sickness in India*

In 1981 the Reserve Bank of India appointed a committee under the chairmanship of Shri T. Tiwari (Tiwari Committee) to examine the legal and other difficulties faced by banks and financial institutions in the rehabilitation of sick industrial undertakings, and suggest remedial measures including changes in the law.<sup>169</sup> The Committee observed that the remedies available under various statutes were

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<sup>167</sup> Part VII, Sections 182-192

<sup>168</sup> Section 191

<sup>169</sup> *Interim Report on the Issue of Special Legislation*, RBI, Delhi, 1981, Para. 1.1

inadequate, and as a result many sick companies which were potentially viable were not being revived. Many of the difficulties faced in rehabilitating sick companies arose because laws like the Companies Act were not primarily meant to deal with the problem of industrial sickness, and even if the laws did refer to it the approach would be sectoral and limited to its own angle rather than based on a co-ordinated view. The Committee recommended that in such a situation it was necessary,

"to get out of the multiplicity of the existing laws and procedures and draw up a special legislation which will enable speedy and effective action to be taken for rehabilitation of the sick units. Such a legislation can create a specialised body exclusively devoted to revival of sick units, which step would ensure unified approach and speedy and time-bound decisions."<sup>170</sup>

In 1985, the Sick Industrial Companies (Special Provisions) Act<sup>171</sup> was enacted to implement the recommendations made by the Tiwari Committee.

#### *Sick Industrial Companies (Special Provisions) Act, 1985*

The purpose of this Act is to provide for preventive, ameliorative, and remedial measures that are essential for reviving sick or potentially sick companies, and for ensuring expeditious enforcement of the schemes of revival devised by the authorities under the Act.<sup>172</sup> In order to achieve the said objects, the Act provides for the establishment of the Board for Industrial and Financial Reconstruction (BIFR) with both administrative and quasi-judicial powers. Under section 15(1) of the Act, it is *mandatory* for a "sick company"<sup>173</sup> to report its sickness to the BIFR within sixty days

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170 *Interim Report on the Issue of Special Legislation*, RBI, Delhi, 1981, Para. 10.1

171 No. 1 of 1986

172 Statement of Objects and Reasons

173 The Reserve Bank of India has defined a "Sick Unit" as one which has incurred cash loss for one year, and in the judgment of the banks is likely to continue to incur cash losses for one year as well as the following year and which has an imbalance in its financial structure such as current ratio 1:1 and worsening debt ratio (total liabilities to net worth) - Tiwari Committee Report, 1981, Para 2.1

of finalising the audited accounts. Where the Board decides a company had become sick but it is practicable for the company to make its net worth positive, reasonable time should be given to the company to do so.<sup>174</sup> Where it is not practicable for a sick company to make its net worth positive within a reasonable time, the Board may direct for rehabilitation.<sup>175</sup>

According to section 22 when an inquiry is pending, or a rehabilitation scheme is under preparation or consideration, or if such a scheme is being implemented, or an appeal against the decision of the Board is pending, no proceedings for the winding up of the sick company, or the execution or distress or such like against the company's assets, or the appointment of a receiver, can be proceeded with, except with the consent of the Board or Appellate Authority. Clearly, section 22 presents a significant obstacle to lending institutions intending to enforce their security rights. The restrictive approach taken by the Indian courts in making orders under this provision has not been encouraging either. There have been a number of cases in the High Courts where creditors of sick companies have argued that their case falls outside the scope of section 22.<sup>176</sup> In *Gram Panchayat v Shree Vallabh Glass Works Ltd.*,<sup>177</sup> the Supreme Court held that, since the company was sick and a rehabilitation a scheme was being prepared under the direction of the BIFR, there was an automatic suspension of legal proceedings against the debtor company's properties. On a more sympathetic note to the creditors, Jagannatha Chetty J added,

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174 Section 17(2)

175 Section 17(3)

176 *Modi Spinning and Weaving Mills Co Ltd. v U.P. State Electricity Board* [1992] AIR (All) 247 ; *The Industrial Bank of India v Nira Pulp and Paper Mills Ltd.* [1992] AIR (Bom) 365; *Navanit R. Kamani v R. Kamani* [1989] AIR (SC) 9

177 [1990] AIR (SC) 1018

"It may be against the principles of equity if the creditors are not allowed to recover their dues from the company, but *such creditors may approach the board for permission to proceed against the company* for the recovery of their dues. If the approval is not granted, the remedy is not extinguished. It is only postponed."<sup>178</sup> (emphasis added)

Although the court accepted that it is against equity not to allow creditors to recover their dues, the temporary suspension of their remedies was justified on the ground that the BIFR had the discretion to allow the proceedings to continue. In practice however, the BIFR may never allow it because its primary concern is to revive the company and if proceedings against the company are allowed to continue the company may have to incur further costs and liabilities and aggravate its financial difficulties.<sup>179</sup> The majority of the decisions given by the Indian courts under section 22 of the Sick Industries Act suggests that courts have shown a great keenness to give effect to provisions of the Act thereby enhancing the prospect of a sick company being revived. Although the courts have not ignored the interests of the creditors completely, the concern shown has been negligible.<sup>180</sup>

#### 4.8.2 *Power of Extra Judicial Sale Under The Transfer of Property Act, 1882*

The Transfer of Property Act does not permit a bank as a mortgagee to exercise

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<sup>178</sup> Ibid., 1020

<sup>179</sup> *Navanit R. Kamani v R Kamani* [1989] AIR (SC) 9 Thakar J at page 18 : "Having given our anxious consideration to the decision rendered by BIFR sanctioning the scheme taking into account all the factors we fully agree with the reasoning and conclusion of BIFR and hereby stamp the scheme with the imprimatur of this court"

<sup>180</sup> In the case of *M/s Shree Chamundi Mopeds Ltd v Church of South India Trust Association* Agarwal J pointed out that the provisions of 22(1) seek to assist in achieving the objectives of the Act and further explained that:

"It could not be the intention of Parliament in enacting the said provision to aggravate the financial difficulties of a sick industrial company while the said matters were pending before the Board of the Appellate Authority by enabling a sick industrial company to continue to incur further liabilities during this period."

[1992] AIR (SC) 1439, at 1445

its power of extra-judicial sale, except in two limited circumstances stated in section 69.<sup>181</sup> First, the mortgage in question must be an English mortgage and no other. Second, both the mortgagee and the mortgagor cannot be a Hindu, Muslim or a Buddhist or be a member of a race, sect, tribe or class officially notified by the state.

The judicial attitude towards extra-judicial sale has so far not been encouraging either. In spite of the safe guards provided for in section 69(2),<sup>182</sup> some Indian judges seem to think that the Transfer of Property Act is "wreaking havoc" to the greater detriment of honest mortgagors. In *Batcha Sahib v Nariman K. Irani Krishnaswamy* Naidu J. while stating that it is a drastic provision, observed:

"while the power of sale without the intervention of Court may be supported and justified in the conditions prevailing in a commercially advanced country like England, where the machinery employed for selling the properties can be said to be perfect and reliable its introduction in India...does not seem to be necessary or justified since from the result of its working it has been found that there is scope for its abuse resulting in great injustice to *bonafide* mortgagors who are likely to be deprived of their properties by an improper and irregular exercise of the power of sale."<sup>183</sup>

#### 4.8.3 Enforcing a Hypothecation in India

A hypothecation is commonly known as a mortgage of movables without giving actual possession to the mortgagee. It is not statutorily defined consequently, the rights and duties of parties to a hypothecation agreement are not governed by statute law. Due to this inadequacy in the law, when a lender enters into a hypothecation

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181 This section has been modelled on the English Conveyancing Act of 1881; presently contained in the English Law of Property Act of 1925 and therefore is in line with the law in England. (41 & 42 Vict. C. 41, 15 Geo. V. Ch. 20)

182 An extra-judicial sale cannot be carried out unless and until :

- a) notice in writing demanding the principal sum has been served on the mortgagor and payment has not been made for three months or
- b) interest of at least Rs. 500/= is in arrears for three months after becoming due

183 [1955] AIR (Mad) 491, at 493

agreement it will safeguard itself by insisting on including a clause that gives it the power to take actual possession of the property from the borrower and sell it if the borrower defaults. In practice, this may prove to be useless for a number of reasons.

According to an agreement between parties, a lender may have the power to take possession of the hypothecated goods, but if the borrower refuses to give possession it will not be lawful for a lender to take possession forcibly. If an attempt is made to take possession without the borrower's consent, the lender may have to face criminal proceedings filed by the borrower on grounds such as wrongful entry, trespass, and breach of peace. Even if the borrower hands over the property willingly, identifying the hypothecated goods may be a problem because the property may not be demarcated. Simply locking up the entire premise with all the goods is obviously not practical. A borrower may actively dissipate the hypothecated goods without the prior consent of the banks thus leaving the security valueless. Similarly, if the goods are of a perishable nature and the borrower does not take adequate safeguards to preserve the stocks, they may have depleted completely. Due to the difficulties faced by lenders to take possession of hypothecated goods, their right to sell the goods will automatically prove to be useless.

The Indian courts have also taken the stand that hypothecation does not always give a lender the power to take possession or to sell the property if the borrower defaults. In *State Bank of India v S.B. Shah Ali*<sup>184</sup> the bank was empowered by a hypothecation agreement to take possession, appoint receivers and sell by public auction goods that were hypothecated to it as security. The bank sold by public auction a lorry that has been hypothecated to it. The District Court held that the bank was liable in

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184 1987 (2) Andhra Law Times Report 470

damages for taking possession of the lorry without first obtaining a court order. On appeal, the High Court of Andhra Pradesh reversed the lower court decision and concluded,

“If there is a mere charge in the hypothecation agreement, the hypothecatee has to approach the court and seek the intervention of the court for obtaining a money decree and selling the hypothecated goods through the court. Where there is any specific clause in the hypothecation agreement, the hypothecatee can proceed without the intervention of the court.”<sup>185</sup>

The law on this issue will not be resolved until it is decided by the Indian Supreme Court. The decision of the High Court has however, further strengthened the case for lenders seeking expeditious enforcement procedures.<sup>186</sup>

#### 4.8.4 *The Sri Lankan Recovery of Loans by Banks (Special Provisions) Act No.4 of 1990*

"One of the greatest impediments to dynamic lending by the Bank of Ceylon and People's Bank has been the archaic debt recovery law of this country..... The World Bank loan will be given to us only if we liberalise our debt recovery laws because the loans will be given through the state banks, the National Development Bank and the DFCC to "the small industrialists, the small agriculturists, of the country.....The Bar Association Of Sri Lanka is the greatest impediment to the two State Banks lending to the farmers, fisherman and other small people of Sri Lanka..”<sup>187</sup>

Heated arguments for and against the reform of the then debt recovery laws in force continued until finally, in 1990 new legislation was introduced streamlining the debt recovery laws and complimenting the expanding commercial activities in the still emerging market economy in Sri Lanka. Although the enactment of this new legislation appears to be somewhat forced, it wrought a change long demanded by the lending community.

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185 [1995] AIR (AP) 134, 143-144

186 Kothari, V., *State bank of India v S. B. Shah Ali : Right to Repossess Assets Exists in Hypothecations too* [ 1998] 13 Journal of International Banking Law 34

187 Rt. Hon. R. De Mel (Then Finance Minister), Hansard, 25 November 1987, 898 - 899

The Recovery of Loans by Banks (Special Provisions) provides for the management or sale of mortgaged property to banks without a court order. The right of management or sale is initiated when the Board of Directors of a bank passes a resolution which is recorded in writing. The resolution is considered conclusive evidence of the authorisation of either the sale or the management of the property.<sup>188</sup> If a foreign bank carrying on business in Sri Lanka through a branch office were to exercise its rights under this statute, the required resolution would have to be passed by the Bank's Board of Directors at its head office, abroad. Each time action needs to be taken to recover a non-performing loan, foreign banks are compelled to follow this time consuming process. Given that debt recovery is part of the routine work in a bank, the law should simplify the position by recognising the general authority given to a management team in Sri Lanka by the Board of Directors. It is important however to ensure that adequate safeguards are provided so that the Board of Directors would ultimately take responsibility for the decisions taken by the local managers.

When a resolution is passed by the Board of Directors of a bank authorising the sale of a property, the lender has a statutory obligation to send a notice to the borrower informing him of the resolution so that the borrower is given an opportunity to take steps to settle the debt even at that stage. This statutory obligation placed upon lenders has adversely affected the debt recovery process because dishonest borrowers use it as a delaying tactic. It was reported that when notice is sent to borrowers they make one or two payments in order to have the sale stopped and then default again.<sup>189</sup>

Where a sale of a property has been authorised by the Board of Directors, the

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188 Sections 4 & 5

189 Interview with Mr. P. Gunasekera, Chief Legal Officer, Peoples' Bank Head Quarters, Colombo, at the Bank, on 14 May 1997.



law allows the board to fix an "upset price" below which the property cannot be sold to any other person other than the bank to which the property is mortgaged.<sup>190</sup> The Act is silent as to criteria to be followed in fixing the upset price. It is possible that banks may fix a nominal amount so that the bank is assured of recovering its dues. It is therefore, important to fix the upset price by taking guidance by an independent valuation. The valuation should apply to all purchasers including the lender as well. When the mortgaged property is sold, the "Board" of the bank must issue a certificate of sale and thereupon all the rights, title and interest of the borrower to and in the property vests with the purchaser of the property.<sup>191</sup> A matter which requires clarification is whether the certificate of sale must be signed by all the members of the "Board" or whether two of its members may sign the certificate on behalf of the Board. Clarification of this word will no doubt help foreign banks.

Where immovable property is to be sold, the Act provides for the possession of the sold property.<sup>192</sup> The Act does not set out a procedure to take possession of movable property which is to be sold in a similar manner. At present banks in the country find it almost impossible to seize property because one of the main reasons is that bank officers seizing property do not have adequate powers to carry out their task.<sup>193</sup> Bank officers must be given powers similar to that of court appointed fiscal officers provided adequate safeguards are taken so that they do not abuse their authority.<sup>194</sup>

If a lender decides not to sell the mortgaged property it can pass the required

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190 Section 11

191 Section 15

192 Section 16

193 Interview with Mr. P. Gunasekera, Chief Legal Officer, Peoples' Bank Head Quarters, Colombo, on 14 May 1997.

194 Section 222 of the CPC

resolution and take over the management of the property in order to recover its dues. The “property” may consist of a large industry or a business and taking over its management by a lender is not an easy task. In countries like the United Kingdom there are qualified insolvency practitioners that are a regulated profession, and they act as receivers and managers. Such receivers and managers are able to decide the best course of action for the benefit of the lender and are reported to have had success in saving enterprises in financial difficulties.<sup>195</sup> But in Sri Lanka, the accountancy and legal professions are yet to provide such specialised services of which lenders may avail themselves.

#### 4.8.5 *Restriction on Receiver’s Powers in Malaysia*

Compared with India and Sri Lanka, the problems encountered by lenders when enforcing security are few. However, there are a few legal, administrative and cultural difficulties faced by lenders in Malaysia. The most notable legal barrier lies in the recent decision of the Federal Court where a receiver’s right of private sale over land charged under the National Land Code was restricted.

##### 4.8.5.1 *The Kimlin Decision*

Until the recent landmark decision of *Kimlin Housing Development Sdn Bhd v Bank Bumiputra Malaysia Berhad*,<sup>196</sup> the power of receivers and managers appointed by debenture holders to sell charged property of a defaulting borrower without judicial

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<sup>195</sup> Flood, J., *The Professional Restructuring of Corporate Rescue : Company Voluntary Arrangements and The London Approach*, Research Report No. 45, Certified Accountants Educational Trust, London, 1995

<sup>196</sup> [1997] 2 MLJ 805

involvement had been recognised.<sup>197</sup> Briefly, the facts of the case were that Kimlin, executed a first legal charge over certain plots of lands in favour of Bank Bumiputra Malaysia under the National Land Code to secure banking facilities. Subsequently, a second legal charge was executed in favour of the same bank. Kimlin also executed a deed of debenture in favour of the bank which created (1) a fixed charge over all its plant, equipment, machinery, motor vehicles and (ii) a first floating charge over all its undertakings, properties and assets, both movable and immovable. In the event of default, the debenture allowed the bank to appoint receivers and managers of the charged property, and they were given the power to take possession of the assets of the company and to sell the assets of the company. Following default by Kimlin, the bank appointed receivers and managers. The debenture did not contain an express provision appointing the receivers and managers as Kimlin's agents consequently, they applied to the High Court for "leave to sell the lands" subject to a statutory charge under the NLC. Subsequent to the application Kimlin went into liquidation. The High Court held *inter alia*, that the receivers and managers were entitled to sell the lands without a judicial sale under the NLC.<sup>198</sup> The liquidator appealed. The Federal Court ruled that the debenture did not confer on the debenture holder a power of sale that was exercisable independently of the provisions of the NLC. Edgar Joseph Jr FCJ said,

"It follows that no power of sale can be conferred by a chargor under the Code on a chargee himself by way of a debenture or power of attorney or otherwise,

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<sup>197</sup> Kamar, S., *Powers and Duties of Corporate Receivers and Managers*, 1996, Malayan Law Journal, Kuala Lumpur, 1996, Cap. 3; Cheang, L., and Chiew, A., *A Legal Impossibility : Arming Chargees with Private Power of Sale of Charged Land Outside the Provisions on the National Land Code*, 1965, [1995] 1 MLJ xxxvi; *United Malayan Banking Corp Bhd v Chong Bun Sun & Another Application* [1994] 2 MLJ 221, 228F-229D; *United Malayan Banking Corp Bhd v Official Assignee and Liquidator of Soon Hup Seng Sdn Bhd (in Liquidation) & Another* [1986] 1 MLJ 75

<sup>198</sup> *Bank Bumiputra Malaysia Bhd & Ors v Kimlin Housing Development Sdn Bhd (in receivership)* [1993] 2 MLJ 126

but proceedings must be brought by the chargee to obtain a judicial sale in accordance with the rigid procedure laid down in the Code. In such circumstances, any power of sale which purports to be conferred on a chargee himself, omitting all mention of notice and periods of default by a debenture or power of attorney and the necessity for obtaining a judicial sale would be invalid and ineffective to entitle a purchaser to be registered as owner...

In our view, the provisions of the Code setting out the rights and remedies of parties under a statutory charge over land comprised in Pt XVI are *exhaustive and exclusive* and any attempt to contracting out of those rights unless expressly provided for in the Code would be void as being contrary to public policy.”<sup>199</sup>

This decision has overturned a long-standing practice of “private sales” of lands by receivers and managers and has caused much furore and anxiety amongst bankers, receivers and managers themselves and their legal advisors. It was reported that

“[a]n emergency but informal meeting had to be held on 17 June 1997 between Bank Negara and most commercial banks in Kuala Lumpur to consider the impact and grave consequences of Kimlin’s decision on the banking industry as well as on the position of receivers and managers and find alternatives or solutions.”<sup>200</sup>

There has been much controversy over this decision. Some authors shared some of the concerns of the bankers and insolvency practitioners and disagreed with the courts decision.<sup>201</sup> Others found the case was rightly decided.<sup>202</sup>

#### 4.8.6 *Muslim Culture in Malaysia*

According to Muslim culture a person is not expected to benefit from the loss of another who becomes worse off as a result of that persons actions. The majority of Malay people are Muslim and follow these practices. Lenders therefore find it difficult to sell

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199 [1997] 2 MLJ 805, 823 - 824

200 Kok, S., *A Review of The Federal Court Case of Kimlin Housing Development Sdn Bhd* [1997] 3 MLJ ci, cvi

201 Kamar, S., *Power of Sales by Receivers and Managers Over Land Under a Debenture*, [1998] 1 MLJ cxxix; Kok, S., *A Review of The Federal Court Case of Kimlin Housing Development SDN BHD*, [1997] 3 MLJ ci

202 Cheang, L., *Eyes for Us to See : The Kimlin Decision*, [1998] 2 MLJ xxxix

property located in areas where the majority are Muslims. These are social realities that banks have to take into account<sup>203</sup>

#### 4.9 CONCLUSION

Efficient debt recovery is necessary to sustain the providers of credit in a modern economy, and the availability of enforceable security goes a long way towards meeting this requirement. The effectiveness of security can be measured by the extent to which it can be enforced expeditiously, and the cost involved. Self-help remedies do not involve judicial involvement, and could be carried out without delay and at low cost. Such remedies are particularly useful to lenders in India and Sri Lanka because there are extensive delays in the judicial system. If the law has provided for extra-judicial enforcement of security lenders must be encouraged to use these remedies, and where the law has not provided for such remedies serious consideration must be given to introduce self-help remedies.<sup>204</sup>

The difficulties faced by the Indian and Sri Lankan credit institutions have more to do with the enforcement of security than its creation. In India, extra-judicial sale is available only in very limited circumstances. When the Transfer of Property Act

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203 Interview with Mr. Ng Chih Kaye, May Bank Head Quarters, Kuala Lumpur, on 30 May 1997.

204 The Indian Banking Laws Committee was very much aware of this problem and recommended that the law should provide for realization of security without judicial intervention. The Commission observed:

“Realisation of security through judicial process is very expensive and time consuming. If the funds of banks and other financial institutions are locked up, other eligible and creditworthy purposes are starved of credit in a period of credit scarcity. Hence, the law should provide for the realisation of dues of banks and other public financing institutions by recourse to the security as far as possible without judicial intervention. The necessity for this is very much apparent as regards these credit purveyors.”

*Report on Personal Property Security Law*, Government of India Press, Delhi, 1977, 102

was enacted in 1882, banks primarily serviced the credit requirements of foreign entrepreneurs. The indigenous borrowers were virtually excluded from accessing credit from banking institutions, and they had to satisfy their borrowing requirements from unscrupulous moneylenders.<sup>205</sup> Laws were therefore enacted to safeguard the interests of the indigenous borrowers by restricting creditors from recovering their secured debts other than by obtaining a court order. This reasoning was appropriate over a century ago but not any longer. It is now time to remove this restriction because the main providers of credit are not moneylenders, but responsible and regulated financial institutions. The Indian Banking Laws Committee recognised that the continuation of this restriction with reference to banking and financial institutions “affects adversely the flow of credit and encourages protracted and vexatious litigation which comes in the way of expeditious debt recovery...”<sup>206</sup> The Committee concluded:

“[t]he *power of Sale* without the intervention of the court should be allowed to all banks and certain notified financing institutions and this should be available to them with reference to all types of advances *other than those made against the security of agricultural land* and should be available independent of the form of the mortgage in their favour.”<sup>207</sup>

These recommendations were not given effect to.

In India, creating a mortgage by the deposit of title deeds, (also known as equitable mortgage) is simple, inexpensive and does not require registration or stamping. These obvious advantages are vitiated by the fact that lenders have to go through the procedure of obtaining a court order to enforce their security rights. This further confirms the point that the Transfer of Property Act must be amended to allow

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205 *Report of the Banking Laws Committee on Real Property Security Law*, Government of India, Delhi, 1977, 31

206 *Report of The Banking Laws Committee on Real Property Security Law*, Government of India, Delhi, 1977, 34

207 Ibid.

extra judicial enforcement of security. In addition, an amendment to the Sick Industrial Companies (Special Provisions) Act 1985 will also have to be made whereby section 22 of the Act does not prevent extra-judicial sales for an unspecified time period. Similarly, a private sale carried out by a provisional liquidator or a liquidator appointed after a receiver must be recognised, by amending the Companies Act accordingly.

Indian law in respect of hypothecation agreements is far from settled. Most importantly, there is a need for the word “hypothecation” to be statutorily defined and the rights and liabilities of the parties to a hypothecation agreement to be clearly set out. In the event of default, the right of a creditor to take possession and sell the secured property without a court order must be included in the statute.

In Sri Lanka, it does not appear as though a substantial overhaul of the law governing the creation and enforcement of security is required. Such a change was required a decade ago, and legislation has been passed bringing about, in instances, radical reform. What needs to be done now is to fine tune the law by introducing legislation remedying the deficiencies that have been identified as impeding the satisfactory working of the existing legislation.

The landmark decision given by the Federal Court of Malaysia in *Kimlin Housing Development Sdn Bhd* has had a number of far reaching implications. Debt recovery will become slow and banks may become cautious about taking land as security from corporate borrowers. At present banks loan up to 80% of the value of the collateral but it is possible that banks may reduce this percentage.<sup>208</sup> It is also possible that debenture holders may opt to wind up a debtor company on the ground that it is unable to pay its debts under section 218(2)a of the Companies Act and then appoint a

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<sup>208</sup> Kamar, S., *Power of Sales By Receivers and Managers Over Land Under a Debenture*,

liquidator for the company. Receivers in Malaysia are also known to hive down viable parts of a company's business, to a subsidiary company and selling the subsidiary as a going concern to recover the debts of the debenture holder. Hiving down may involve dealing with charged land under the NLC as well as a debenture, and in such circumstances receivers will be prevented from hiving down viable parts of an enterprise.

Urgent legislative reform is required in India. The *Transfer of Property Act* must be amended to remove the legal obstacles present when creating and enforcing security. Whilst the introduction of remedial legislation is vital, a greater credit consciousness is also required of the judiciary and the legal fraternity if credit institutions are to thrive. However, the Sri Lankan experience shows that judicial attitudes, as well as the practices of lawyers, which have been conditioned over a long period of time are not easily changed.



## CHAPTER FIVE

### ***RECOVERY THROUGH THE COURTS***

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- 5.1 *INTRODUCTION*
  - 5.2 *ORDINARY ACTIONS IN INDIA AND SRI LANKA*
  - 5.3 *ORDINARY ACTIONS IN MALAYSIA*
  - 5.4 *SUMMARY PROCEDURE*
    - 5.4.1 *Objective*
    - 5.4.2 *Summary Procedure in India and Sri Lanka*
    - 5.4.3 *Summary Procedure in Malaysia*
  - 5.5 *DEBT RECOVERY SUITS FILED UNDER SPECIAL LEGISLATION*
    - 5.5.1 *The Indian Recovery of Debts Due To Banks and Financial Institutions Act, 1993*
    - 5.5.2 *The Sri Lankan Debt Recovery (Special Provisions) Act of 1990*
  - 5.6 *WINDING UP IN INDIA, SRI LANKA AND MALAYSIA*
  - 5.7 *RECEIVERSHIP IN INDIA, SRI LANKA AND MALAYSIA*
  - 5.8 *DELAYS IN THE COURTS*
    - 5.8.1 *Causes of Delay and Backlog of Cases*
  - 5.9 *CONCLUSION*
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#### 5.1 *INTRODUCTION*

The debt recovery crisis has had a wide spread negative impact on economic growth in most developing countries.<sup>1</sup> Investment has been impeded as a consequence of increased lending costs and the denial of credit to many borrowers.

If debt recovery proves to be difficult, banks and financial institutions will become more averse to risk and be unwilling to lend to borrowers without adequate security.<sup>2</sup> As has been seen, lenders favour real property security, and as a result a large number of persons who are unable to provide established collateral are denied access to credit,<sup>3</sup> thus perpetuating inequalities in society. If a lender has to go to court to enforce its security, it will benefit the lender only at the stage of execution. The property therefore is

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<sup>1</sup> *World Development Report*, Oxford University Press, New York, 1989, 2-3, 70-78

<sup>2</sup> Berger, A., and Udell, G., *Collateral, Loan Quality and Bank Risk* (1990) 39 *Journal Of Monetary Economics* 21

<sup>3</sup> Sarap, K., *Transactions in Rural Credit Markets in Western Orissa* (1987) 15 *India*

effectively removed from the market until the process of litigation, sometimes spread over many years, is over. As a result, large amounts of real estate tied up as security to loans, is immobilised, and cannot be used in a more productive manner.

When the legal process for the recovery of over-due debts becomes excessively long, it may further encourage dishonest borrowers to exploit deficiencies in the system.<sup>4</sup> These borrowers may obtain loans with the deliberate intention of avoiding payment or, where loans have already been obtained, discontinue repaying the loan because of the well known delays experienced in the courts. These defaulters also take an unfair share of the new credit in the form of unpaid interest and capital, depriving more deserving borrowers of this credit. It is also likely that such a borrower would have invested the credit unwisely. Economic returns generated from the credit facility may therefore be marginal or even non-existent. On the other hand, honest borrowers who are fully conscious of their obligations to a lender are indirectly penalised by being required to pay high interest rates.

Timely repayment of loans is important to ensure the financial soundness of lenders. Where borrowers are in default, lenders may reschedule loans, but ultimately they rely on recovery procedures and the courts to compel debtors to pay up. If the courts and the judicial system in a country fail the lenders, bad debts will begin to mount in number. As has been said earlier this will inevitably have a negative impact on the economy as a whole.

This chapter will examine the judicial remedies presently available to lenders to recover debts from defaulting borrowers. The remedies available will be described, and an attempt will be made to identify why, if at all, they are ineffective. Possible solutions will

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Journal Of Peasant Studies 83, 93

<sup>4</sup> Murgatroyd, P., *Legal Management Aspects of Debt Recovery: Lessons to be Drawn and Where Do We Go From Here*, Paper Presented at the Regional Symposium on Legal Issues in Debt Recovery, Credit and Security, Manila, 1993, 1-3

then be suggested.

## 5.2 ORDINARY ACTIONS IN INDIA AND SRI LANKA

A lender seeking to recover money it has lent together with unpaid interest there on has the right to institute a suit in any civil court that has jurisdiction against a defaulting borrower and to seek recovery from court. Both in India and Sri Lanka, civil suits are governed by the respective Codes of Civil Procedure.<sup>5</sup>

The Sri Lankan Civil Procedure Code is based primarily on the Indian Civil Code. In addition, some parts are based on the Civil Procedure Code of New York of 1880 and the English Rules of the Supreme Court framed in 1883 and 1885 under the Supreme Court Judicature Act.<sup>6</sup> Since the Sri Lankan Civil Procedure Code is based on its Indian counterpart, most of the statutory provisions are virtually identical. The procedures governing ordinary actions as well as summary actions are the same. Therefore, to avoid repetition, these two procedures will be discussed together. Attention will however be drawn to such differences as there may be.<sup>7</sup>

In both jurisdictions, a bank may institute an ordinary debt recovery suit by presenting a written plaint to a court<sup>8</sup> of competent jurisdiction.<sup>9</sup> The jurisdiction of a court may be limited in respect of the value of the action, subject matter of the action, or

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<sup>5</sup> India - Act No V of 1908, Sri Lanka - Legislative Enactments of Sri Lanka, Vol.V, 1980 (Revised), Chapter 105

<sup>6</sup> See the comments of the Commission headed by Sir Samuel Grenier, appointed to draft the Sri Lankan Civil Procedure Code, in *The Ceylon Sessional Papers*, Vol XXIII, Government Printer, Colombo, 1955, 3

<sup>7</sup> Saha, A., *The Code of Civil Procedure*, Vols. 1&2, 5th Ed., Premier Publication Co., Allahabad, 1996; Nand Lal., *The Code of Civil Procedure, Act No V of 1908*, 3rd Ed., Law Publishers (India) Pvt. Ltd., Allahabad, 1996; Wickremesinghe, K., *Civil Procedure in Ceylon*, Wesley Press, Colombo, 1971

<sup>8</sup> Every plaint must show the defendant's interest and liability to be sued and a statement of facts setting out the jurisdiction of the court. India - Section 26 & Order 7; Sri Lanka - Section 39

<sup>9</sup> India - Section 7, Sri Lanka - Section 9

the area over which the jurisdiction extends. In India, the District Courts do not have pecuniary limitations thus these courts have jurisdiction to hear all debt recovery suits irrespective of the value of the claim involved.<sup>10</sup> In Sri Lanka, the District Courts can entertain civil actions where the claims are more than Rs. 750/=.<sup>11</sup> The court will thereafter order summons to be issued to the defendant ordering him to appear before it on a given date to answer the claim filed against him.<sup>12</sup> A process server entrusted with the duty of serving a summons must make every endeavour to effect summons personally,<sup>13</sup> but if the defendant refuses to acknowledge the service of summons, it could be served by affixing a copy of it on the outer door of his house.<sup>14</sup> If, however, the defendant avoids actual service, substituted service is possible after obtaining a court order.<sup>15</sup> In India, court may also order summons to be served by registered post in lieu of, or in addition to, actual or substituted service.<sup>16</sup> When an acknowledgement of summons signed by the defendant is filed in court, or when the defendant or his agent refused to acknowledge summons, the court issuing the summons is required to declare that the summons had been duly served on the defendant. The same rule applies when summons is served by registered post.<sup>17</sup> In

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10 Thakkar, C., *Civil Procedure*, 3rd Ed., Eastern Book Company, Lucknow, 1994, 30

11 Wickremesinghe, K., *Civil Procedure in Ceylon*, Wesley Press, Colombo, 1971, 43

12 India - Order 5 Rule 1; Sri Lanka - Section 55

13 In *Babun Nona v Ariyasena*, the process server claimed that summons were delivered to the defendant's husband while she was inside the house which the defendant denied. The Supreme Court of Sri Lanka held that the statutory requirement had not been complied with and that such provisions are imperative and should be strictly observed. (1957) 56 NLR 575

14 A temporary absence of the defendant from his house does not justify the process server affixing the summons to a door of his house. It is the duty of the process server to take pains to find out where the defendant is in order that, if possible, personal service may be effected. *Subramaina Pillai v Subramania Ayyar* (1898) 21 ILR (Mad) 419

15 India - Order 5 Rule 20; Sri Lanka - Section 60

16 India - Order 5 Rule 19A

17 The Law Commission of India observed that a number of cases had been reported where injustice had been done to defendants due to fraudulent activities of plaintiffs with the assistance of dishonest postmen motivated to make a false endorsement regarding refusal.

Sri Lanka, service by registered post is possible only where a liquid claim is made under summary procedure.<sup>18</sup>

On the day stated in the summons, both the plaintiff and the defendant must be present in court either in person or by their respective attorneys and the defendant must file a written statement of his defence in court.<sup>19</sup> The court will, thereafter, fix a date for the trial. Where the defendant does not appear and it is proved that a summons was duly served and that his absence was intentional, the court may order the suit to be heard *ex parte*.<sup>20</sup>

At the pre-trial stage any party may, without filing an affidavit, apply to court for an order directing the other party to the suit to disclose on oath all the documents that may be relevant for the trial which are or have been in his possession.<sup>21</sup> If court decides that the discovery of documents will enable the suit to be disposed of more effectively without unnecessary delay and save costs, it may make an order for discovery.<sup>22</sup> On the other hand, if it is clear to court that no good can reasonably be expected to come from ordering it, court can refuse the application for discovery.<sup>23</sup>

At the trial, issues will be framed, oral and documentary evidence will be recorded and arguments by both parties will be advanced. After the case has been fully

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The Committee therefore recommended that section 19A must be amended to remove the mandatory nature of the section and leave it to the discretion of the court to declare whether refusal should be deemed to be equivalent service. *140th Report of The Law Commission on the Need to Amend Order V Rule 19A with a view to Foreclose Likely Injustice*, Government of India, Delhi, 1991, 10-11

18 Sri Lanka - Section 705A and 705B

19 India - Order 9 Rule 1, Sri Lanka - Sections 73-74

20 Takwani, C., *Civil Procedure*, 3rd Ed., Eastern Book Co., Lucknow, 1994, 166; Wickremesinghe, K., *Civil Procedure in Ceylon*, Wesley Press, Colombo, 1971, 438-439

21 India - Order 11 Rule 12, Sri Lanka - Section 102

22 India - Order 11 Rule 20 Wickremesinghe, K., *Civil Procedure in Ceylon*, Wesley Press, Colombo, 1971, 161-163

23 *Weerasuriya v Croos* (1920) 22 NLR 87

heard, the court will pronounce its judgement in open court either on that day or on a future date.<sup>24</sup> Once judgement is given it is followed by a decree.<sup>25</sup> If a plaintiff is unhappy with the judgement, he can appeal to the Court of Appeal against the judgement on a question of law or mixed fact and law<sup>26</sup> and then to the Supreme Court.

Having obtained a decree from a court to recover the outstanding debt from the judgement debtor the lender must then proceed to execute the decree.<sup>27</sup> A decree to pay money can be executed by the seizure and sale of movable and immovable property of the debtor.<sup>28</sup> Where the decree is for any specific movable property, that property can be seized and sold. If the decree is for the recovery or delivery of possession of immovable property, it is enforced by the issue of a writ of execution to the Fiscal.

The only method available to execute a decree is through Fiscal Officers. The prevailing fiscal service in both countries has grave deficiencies and as a result execution of decrees has become a long and arduous process.

### 5.3 *ORDINARY ACTIONS IN MALAYSIA*

Malaysia has a three tiered superior court system with the Federal Court as the highest court of law in the country.<sup>29</sup> The next highest court is the Court of Appeal and thereafter the High Courts. All these courts can entertain appeals from the Subordinate

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24 India - Section 33, Judgement must be made before thirty days have expired from the date of the trial. Sri Lanka - Section 184

25 India - Section 33, Sri Lanka - Section 188

26 India - Section 96, Sri Lanka - Section 754

27 India - Part II, Section 36-74, Chaturvedi, R., B.N. Banerjee on Law of execution, 4th Ed., The Law Book Co., Allahabad, 1994, Chapter 8; Sri Lanka - Chapters 22-23, Wickremesinghe, K., *Civil Procedure in Ceylon*, Wesley Press, Colombo, 1971, Chapter 16

28 India - Part II, Section 60, Sri Lanka - Chapter XXII, Part A

29 Prof. M. Majid & T., Abdul Rashid, *The Courts in Malaysia and their Jurisdiction* (1995) 21 Commonwealth Law Bulletin 297; Ong Kok Bin, *The Civil Court in Action*, Pelanduk Publications, Kuala Lumpur; 1995, Chapter 3

Courts which include the Magistrates and the Sessions Courts.<sup>30</sup>

In Malaysia, there are two classes of magistrates, a First Class Magistrate and Second Class Magistrate.<sup>31</sup> A First Class Magistrate has the jurisdiction to hear a cause of action where the amount in dispute does not exceed RM. 10,000/= <sup>32</sup> A Second Class Magistrate has jurisdiction to hear cases where the amount of the claim does not exceed RM. 25,000/=. The Sessions Courts have jurisdiction to try all suits of a civil nature where the amount in dispute does not exceed RM. 250,000/= <sup>33</sup> The High Courts have unlimited jurisdiction.

A plaintiff lender has the right to file action in any one of the Subordinate Courts or the High Courts, but the choice of court will eventually be determined by the value of the claim in contention. The court procedure to be followed is set out in the respective rules of the courts.<sup>34</sup> In both courts the rules are very similar except that in some instances the Subordinate Court Rules are simpler. For ease of discussion a typical debt recovery procedure in the High Court will be discussed while making references to the Subordinate Court procedure.<sup>35</sup>

A debt recovery suit can be commenced either by a writ of summons, originating

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30 In 1994, there were a number of changes in the Malaysian Constitution relating to the Judiciary. Article 121 was amended so that a new Court of Appeal was founded and the existing Supreme Court was replaced by the Federal Court as the Highest Court. See Constitution (Amendment) Act 1994, and Courts of Judicature (Amendment) Act 1994.

31 A first class magistrate has jurisdiction to hear civil suits but a second class magistrate's role is to assist a first class magistrate by performing routine functions such as signing warrants and summons when a first class magistrate is not available. As a general rule, second class magistrates are not encouraged to hear cases.

32 Section 10, Subordinate Court (Amendment) Act, 1978

33 Section 65(1), Subordinate Court Act, 1948 amended by section 4 of the Subordinate Courts Act, 1978

34 Subordinate Court Rules 1980 (P.U. (A) 328/80) and Rules Of The High Court 1980, (P.U. (A) 50/80) (hereafter referred to as SCR and RCH respectively)

35 Chang, G., *Introduction to Civil Procedure in Malaysia & Singapore*, 3rd Ed., Butterworths Asia, Kuala Lumpur, 1994; Abu Backer, H., *Janab's Key to Civil Procedure in Malaysia and Singapore*, 2nd Ed., 1995

summons, originating motion or petition,<sup>36</sup> the most common form of procedure being the one instituted by a writ of summons. A writ so filed is like a command, informing the defendant to register an appearance within 8 days from the date of service of the writ because failure to do so will entitle the plaintiff to obtain judgement in his favour and commence execution proceedings.<sup>37</sup> A writ may be issued by depositing with the Court Registrar copies which will then be served on the defendant. Normally, a writ can be served on the defendant personally but where his Solicitor has agreed to accept service it may be effected accordingly. Unlike in India and Sri Lanka, special court officers are not required to serve the writ, and if necessary the plaintiff may himself do so. Where it is impracticable to effect personal service, substituted service is possible<sup>38</sup> after first obtaining a Court order.<sup>39</sup>

Once the writ has been served on the defendant, he has the choice of "entering appearance" or simply defaulting. Entering appearance means that the defendant informs the court that he wishes to defend the claim against him and gives notice to the Registrar by completing a memorandum of appearance (Form 15) in duplicate and handing it over to him within the stipulated time limit. The Registrar will then allocate a date and time for

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36 RCH Order 5 Rule 1, SCR Order 4

37 The summons must be based on Statutory Form No.2 and indorsed with the names and addresses of the parties (where applicable the names and addresses of the Solicitors). A statement of claim and another claim of costs and a statement to the effect that action will be stayed if the amount claimed and the costs are paid into Court. See RCH Order 6 & SCR Order 5

38 Substituted service can be effected by posting a copy of the writ on the door of the house in the defendants last known address and on the notice board of the court issuing the writ and also publishing it in a local news paper. See RCH Order 62 Rule 5 & SCR Order 7 Rule 18(1)

39 "The intention which underlies all procedure with regard to substituted service is that the defendant will probably get to hear of the proceedings" per Romer L.J. in *Deverall v Grand Advertising Inc* [1954] 3 All ER 389, 396; *Sockalingam Chettiar & Ors v Somasundaram Chettiar* [1941] 1 MLJ 103



appearance and inform the defendant either in person or by post.<sup>40</sup> If the defendant does not enter appearance within the specified time, judgement will be given in favour of the plaintiff without a trial.<sup>41</sup>

Where the defendant appears in court on the given date and disputes the plaintiff's claim, the court will make an order directing him to file a defence, usually within two weeks.<sup>42</sup> Unfortunately, the Subordinate Court Rules do not specify a time limit, which causes unnecessary delays.

In the run up to the trial, there are a number of pre-trial proceedings that must be followed, all aimed at preparing the suit for an expeditious trial. The first is discovery and inspection of documents.<sup>43</sup> The basis for making an order for discovery is only if it is necessary to dispose of the suit quickly or for saving costs.<sup>44</sup> The second is the application by summons for directions i.e. the parties may apply to court seeking directions as to matters that were raised in the pleadings and how the evidence is to be presented at the trial. At this stage, the Court has the power to fix a date for the trial and also indicates the estimated length of the trial and the approximate number of witnesses (if any). The procedure is in fact by nature a "stocktaking" process, whereby the Court can consider whether the case is ready to be tried and also can ascertain whether all the evidence is available so that it can assist the Court adjudicating the matter. Where directions are sought in this manner, it reduces the number of interlocutory applications before and in the course of the trial, and the overall effect is that it gives the Court an opportunity to give

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40 RCH Order 12

41 There are a number of requirements that must be complied with before a judgement in default can be signed. If any of the requirements have not been complied with before default judgement is given it can be set aside for irregularity at the cost of the plaintiff. *Fabrique Ebel Societe Anonyme v Syarikat Periagaan Tukang Jam City Point & Ors* [1988] 1 MLJ 188

42 RCH Order 18 Rule 2 & SCR Order 14 Rule 5

43 RCH Order 24

such directions that will dispose of the action in a just, expeditious and economical manner. The third pre-trial procedure is the asking of questions from the other side, generally known as directing interrogatories. Unlike discovery of documents, interrogatories refer to the discovery of facts which involves asking questions that usually relate to the action.<sup>45</sup> The answers that are given in reply become part of the pleadings.<sup>46</sup>

After all the pre-trial proceedings are completed, the case is ready for hearing.

On the date of the trial if the plaintiff fails to attend the hearing the action may be struck off and the counterclaim against him heard. If the defendant fails to attend, the case will be heard *ex-parte* and his counterclaim, if any, dismissed. Any judgement obtained in this manner may be set aside on an application made to court within seven days. There is a strong possibility that the Court will award costs against the defaulting party. Judgement will be pronounced in open court immediately on the conclusion of the trial or on a subsequent date and notified to all parties.<sup>47</sup>

Where the suit is for the recovery of a debt, court may give judgement for the payment of money, possession of land, or for the delivery of goods belonging to the debtor. When the party against whom the judgement was given refuses to comply with the order given by the court, it becomes imperative for the plaintiff to seek assistance from the Court to enforce the judgement. The enforcement procedure will vary according to the nature of the judgement.<sup>48</sup> If the judgement is for the payment of money, it may be

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44 *Rank Film v Video Centre* [1980] 2 All ER 273, C.A

45 Questions that do not relate to the dispute will not be allowed. For example, interrogatory proceedings cannot be made use of to obtain evidence for use in a subsequent action. *Pertubohan Berita National Malaysia v Stephen Kalong Ningkan* [1980] 2 MLJ 19 (FC)

46 RCH Order 26 & SCR Order 21

47 RCH Order 42 & SCR Order 29

48 Ong Kok Bin, *The Civil Court in Action*, Pelanduk Publications, Kuala Lumpur, 1995, Chapter 12

enforced by a writ of seizure and sale<sup>49</sup> and if it is for the possession of land it may be enforced by the issue of a writ of possession.<sup>50</sup> In the case of a judgement for the delivery of movables, a court may issue either a writ for specific delivery, with an alternative for the recovery of the assessed value of the property or, issue a writ for specific delivery only.<sup>51</sup>

## 5.4 SUMMARY PROCEDURE

### 5.4.1 Objective

The object underlying summary procedure is to enable a plaintiff to obtain a judgement without delay, preventing a defendant unreasonably obstructing the litigation process, by advancing spurious defences. In *Jacobs v Booth's Distillery & Co.*, Lord Halsbury LC said:

" people do not seem to understand that the effect of O.14 (Order governing summary procedure in the United Kingdom) is that, upon the allegation of the one side or the other, a man is not permitted to defend himself in court; that his rights are not litigated at all. There are some things too plain for argument; and where there were pleas put in simply for the purpose of delay, which only added to the expense, and where it was not in aid of justice that such thing should continue, O.14 was intended to put an end to that state of things, and to prevent sham defences from defeating the rights of parties by delay, and at the same time causing great loss to the plaintiffs who were endeavouring to enforce their rights."<sup>52</sup>

If a plaintiff can prove that the case is straightforward and that the defendant has no case to answer, a judge has the discretion to deal with the action under summary procedure, in order to avoid delay.<sup>53</sup> The discretion given to a judge is indeed a wide power, and it is the

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49 HCR Order 47 & Form 88 (titled "Writ of Seizure and Sale"), SCR Order 30 Rule 1

50 Order 45 Rule 3 & Form 90 (titled "Writ of Possession"), SCR Order 30 Rule 3

51 Order 45 Rule 4 & Form 89 (titled "Writ of Delivery"), SCR Order 30 Rule 4

52 (1901) 85 Law Times 262 (HL)

53 In *British & Commonwealth Holdings Plc v Quadrex Holdings Inc.*, Brown Wilkinson

duty of the judge to give judgement in favour of the plaintiff, if he were satisfied that there is no dispute worth arguing. As Esher M.R. said in *Roberts v Plant*,

"It is a strong thing to give such a power to a judge, and this Court and all the Courts have said, therefore, that they would watch strictly the exercise of that power. But they did not mean by that they would give effect to every pettifogging objection which the ingenuity of a defendant could raise.<sup>54</sup>

#### 5.4.2 Summary Procedure in India and Sri Lanka

A plaintiff bank wishing to recover its debts has the option of bringing a suit under the ordinary procedure or alternatively, bringing a suit under summary procedure. In both countries the law governing summary actions is almost identical.<sup>55</sup> Summary procedure can be used to recover debts only in certain types of commercial actions namely, suits for the recovery of dues on negotiable instruments, liquidated demands arising under a written contract, and under an enactment or guarantee.<sup>56</sup> As in ordinary actions, suits are instituted by presenting a plaint but summons are served on a special form.<sup>57</sup> The defendant is not entitled to defend the claim against him as of right, but can apply to court for leave to defend. The court may refuse leave or, if it is satisfied that there is a "triable issue" or the facts disclosed by the defendant show that the defendant has a substantial defence, leave may be granted unconditionally or upon conditions which appear to the court to be just.<sup>58</sup> In *Raj Duggal v Ramesh Kumar Bansal*<sup>59</sup> the Indian

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VC said, "O 14 procedure is for clear cases and not for complicated cases which absorb many days to unravel" [1989] 3 All ER 492 at 512

54 (1895) 14 The Reports 222, 226

55 India - Order 37; Sri Lanka - Sections 703-711 of the respective Civil Procedure Codes

56 India - Order 37 Rule 1; Sri Lanka - Section 703

57 India - "Summons in summary suits on negotiable instruments" Appendix B Form 4 & 4A, Sri Lanka - "Summons in an action of summary procedure on a liquid claim" Schedule 1, Form No.19

58 India - Order 37 Rule 3; Sri Lanka - Section 706

59 [1991] 1 SCC (Supp) 191, 191-192

Supreme Court set out the following guidelines:

"The test is to see whether the defence raises a real issue and not a sham one, in the sense that if the facts alleged by the defendant are established there would be a good or even plausible defence on those facts. If the court is satisfied about that leave must be given. If there is a triable issue in the sense that there is a fair dispute to be tried as to the meaning of a document on which the claim is based, or uncertainty as to the amount actually due or where the alleged facts are of such a nature as to entitle the defendant to interrogate the plaintiff or to cross-examine his witnesses leave should not be denied. Where also, the defendant shows that even on a fair probability he has a bona fide defence, he ought to have leave. Order 37 should not be granted where serious conflict as to matter of fact or where any difficulty on issues as to law arises. The court should not reject the defence of the defendant merely because of its inherent implausibility or its inconsistency."

In India, where the court has granted conditional leave, the condition normally imposed by it is that either the full or part of the sum in contention is first deposited in court.<sup>60</sup> The position in Sri Lanka is slightly different. Section 704(2) of the Civil Procedure Code specifically states that, depositing in court the sum mentioned in the summons, or giving security should not be a condition for granting leave, unless the court thinks the defence is not prima facie sustainable or there is a doubt as to its good faith.<sup>61</sup> If the defendant has not applied for leave to defend the claim, or such application has been refused by the court, the plaintiff is entitled to judgement. Where leave to defend has been granted, the procedure thereafter is the same as in actions under the regular procedure.

Summary procedure is designed to settle disputes between parties when there is no arguable defence, and as quickly as possible with minimum cost. It is therefore an ideal procedure for banks to follow to recover their debts from defaulting borrowers, but in practice, both in India and Sri Lanka banks do not seem to be using this procedure extensively. At least two reasons common to both countries can be suggested. First, most bank suits involve a claim for the outstanding debt and for the enforcement of security it

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<sup>60</sup> Order 37 Rule 3(2) *Sarmon Pte Ltd., v Umesh Kumar Kajaria & Another* (1995) 1 SCC Supp. 443

<sup>61</sup> *Natchiappa Chetty v Tambyah* (1896) 6 NLR 205

has taken from the borrower, but summary procedure can be utilised only to recover a debt or a liquidated money claim, thus barring the claim regarding security being filed under this procedure. This problem can easily be remedied by amending the law to allow a joint claim for the recovery of the outstanding loan as well as the enforcement of security. Second, the excessive delays and backlog of cases in both the legal systems have also nullified the effectiveness of the procedure.<sup>62</sup>

In Sri Lanka, there is a misconception as to the meaning of the term "debt or a liquidated demand in money." In a well known case *Sabapatipillai v Jaffna Trading Co.*<sup>63</sup> the Supreme Court held that the "instrument or contract in writing for a liquidated amount referred to in section 703 must be of the same nature as the documents referred to immediately before the expression, namely, a bill of exchange, promissory note or cheque. This is a result of the well-known principle of interpretation, the "*ejusdem generis rule*." If this section can be amended by omitting reference to the specific instruments, i.e. the bills of exchange, promissory note and cheque and redefining the term "debt or liquidated demand in money" by including a provision that states it is a "specific sum of money arising out of a contractual obligation that has not been disputed," in other words an outstanding amount of money that is due to the creditor without a doubt what so ever, lenders may not consider this an obstacle any longer. In 1985, the Wimalaratne Committee suggested a definition based on an explanatory note given in Order 6 Rule 2 Note 4A of the English Supreme Court Rules, but the Bar Association of Sri Lanka objected to the proposed definition and the governments in office since then have not pursued the

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<sup>62</sup> See the observations of the Indian Law Commission in its *79th Report on Delay and Arrears in High Courts and Other Appellate Courts*, Government of India, Delhi, 1979, 3 and The Wimalaratne Committee on *The Law and Practice Relating to Debt Recovery in Sri Lanka*, Sarvodaya Vishva Lekha, Ratmalana, 1985, 3

<sup>63</sup> 4 Ceylon Recorder 210

matter.<sup>64</sup> The recommendation of the Wimalaratne Committee has much to commend. An amendment to Order 37 rule 2 of the Indian Civil Procedure Code on the same lines will extend the scope of the application of summary procedure to more suits filed in India.

#### 5.4.3 *Summary Procedure in Malaysia*

Like in most other jurisdictions, summary procedure in Malaysia is designed to provide justice without delay if the debt is virtually incontestable. Subordinate Courts as well as High Courts have jurisdiction to hear summary actions. The procedure followed in both Courts is identical except where the rules have been amended by the Subordinate Courts (Amendments) No.2 Rules of 1981.<sup>65</sup> Summary procedure can be used for most actions initiated by summons.<sup>66</sup> Where the claim is an action for specific performance or for the possession of land, summary procedure is used but it is different to the usual procedure due to special rules that are applicable.<sup>67</sup>

A plaintiff resorting to summary procedure must ensure that three conditions are satisfied.<sup>68</sup> First, the defendant must have entered an appearance. Second, the statement of claim must be completed, filed in court and a copy served on the defendant. Third, the affidavit in support of the application must verify the facts on which the claim is made and

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<sup>64</sup> The Bar Association was of the view that the existing section should not be tampered with but did not suggest an alternative amendment that would resolve this misconception. Members of the Bar Association are themselves not clear in their minds as to the merits of the proposed definition, some construing it as widening the scope of the existing provision, while others take the view it narrows the scope. See *Report of The Bar Association Presented at the Seminar on the Proposed Debt Recovery Legislation*, Ministry of Justice, Colombo, 1987, 6 & 9

<sup>65</sup> Hamid, N., and Ravichandren, S., *Summary Judgement*, Central Law Book Corporation, Kuala Lumpur, 1993

<sup>66</sup> The exceptions are where the claim by the plaintiff is for libel, slander, malicious prosecution, false imprisonment, seduction or breach of promise of marriage or a claim based on allegations of fraud. HCR Order 14 Rule(1)(2) a & b, SCR Order 26A Rule (1)(a)

<sup>67</sup> HCR Order 14 Rule 1(3)

<sup>68</sup> HCR Order 14 Rule 1, SCR Order 26A Rule 2

state that according to the deponents belief there is no defence to the claim except as to the amount of any damages claimed.<sup>69</sup> The court, however, has the power to request for additional proof of the facts if necessary. Summary procedure will be commenced by serving a summons, together with an affidavit, in support of the claim, at least four days before the return date mentioned in the summons.<sup>70</sup> The summons and affidavit may be served by post or by leaving it at the address given by the defendant in his memorandum of appearance. Personal service is not essential.

The Court Registrar has jurisdiction to decide summary cases brought before the Court, and the hearing is usually conducted in his chambers. If the Registrar is of the opinion that the matter must be decided by a judge, he will refer the case to a judge.

At the hearing, if the defendant wishes to resist the application for summary judgement, he can file a counter-affidavit and claim that there is a triable issue<sup>71</sup> or raise a bona fide defence. In the case of *Cheng Hang Ping & Ors v Intradagang Merchant Bankers (M) Bhd* the Court of Appeal held that denials in a defence do not constitute evidence because they are only challenges to the other side to show proof. The triable issues will be decided upon the "merits of the case" which means that there must be a difficult question of law or a substantial question of fact involved. If the Registrar decides that there is a triable issue or a bona fide defence, he will dismiss the application for summary judgement with costs to the defendant and grant leave to defend the case. The order may be conditional whereby the defendant is required to pay into court the amount

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<sup>69</sup> *Pembinaan KSY Sdn Bhd v Lian Seng Properties Sdn Bhd & Another* [1993] 1 MLJ 316

<sup>70</sup> HCR Order 14 Rule 2(3), SCR Order 26A Rule 2(3) - The Subordinate Courts (Amendment) No.2 Rules of 1981 amended this rule by substituting the word "summons" with the word "notice".

<sup>71</sup> In *Keppel Finance Ltd., v Phoon Ah Lek* [1994] 3 MLJ 26 the defendant argued that he should have been given unconditional leave to defend the case as there were triable issues. The court held that although the questions of law on which the Order 14 application was based were not simple ones, the answers to the questions posed were clear and unarguable.



of the claim or provide security to the value of that claim.<sup>72</sup>

If on the other hand, the Court Registrar decides that the case is virtually incontestable because all the issues are clear and the matter of substance can be decided once and for all, leave to sign summary judgement will be given.<sup>73</sup> A party aggrieved by the Registrar's decision has the right to appeal to the Judge in Chambers.

## 5.5 DEBT RECOVERY SUITS FILED UNDER SPECIAL LEGISLATION

### 5.5.1 *The Indian Recovery of Debts Due To Banks & Financial Institutions Act, 1993*

In 1981, the Tiwari Committee examined the legal and other difficulties faced by the banks and other financial institutions. During their study the Committee recognised that large amounts of money advanced by the banks and other financial institutions were blocked as unproductive assets because legal actions filed against defaulting borrowers were subject to excessive delays due to the existing legal procedure and process of recovery in India. The Committee therefore recommended that,

"[t]he Central Government may set up a class of tribunals which would in summary way but following the principles of natural justice adjudicate finally, within a time bound schedule, all matters in relation to recovery of dues of the banks and financial institutions"<sup>74</sup>

Later in 1991, another committee appointed to study the Indian financial system and reforms under the chairmanship of Shri M. Narasimham also emphasised that the introduction of new legislation for the recovery of debts is long overdue and observed,

" that there is urgent need to work out a suitable mechanism through which

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<sup>72</sup> *QBE Supreme Insurance & Ors v Syarikat Chemas Pemborong Sdn Bhd & Ors* [1986] 1 MLJ 56

<sup>73</sup> *Citibank NA v Ooi Boon Leong & Ors* [1981] 2 MLJ 282 (FC)

<sup>74</sup> *Report of The Committee Appointed to Examine the Legal and Other Difficulties Faced by Banks and Financial Institutions in Rehabilitation of Sick Industrial Undertakings and Suggest Remedial Measures Including Changes in the Law*, Reserve Bank of India, Bombay, 1984, 77 (Tiwari Committee Report)

the dues to the credit Institutions could be realised without delay and strongly recommends the Special Tribunals on the pattern recommended by the Tiwari Committee on the subject be set up to speed the process of recovery."<sup>75</sup>

Finally in 1993, almost a decade after the Tiwari Committee made their recommendations, the Indian Parliament enacted the Recovery of Debts Due to Banks and Financial Institutions Act.<sup>76</sup> (Hereafter RDBF Act) The Act provides for the Central Government to establish special tribunals that are quasi judicial in nature, to adjudicate exclusively on the debt recovery actions of banks and financial institutions in a summary way.<sup>77</sup> It also provides for the establishment of appellate tribunals. The Tribunals will be presided over by a presiding officer.<sup>78</sup>

If an institution falls within the definition of a bank or financial institution under the Act, it no longer has to seek recourse from the Indian civil courts, but can pursue an application for an order before a Debt Recovery Tribunal. A lender may commence proceedings by filing an application in a tribunal that has jurisdiction and plead for an order in its favour. On receipt of an application, the tribunal must issue a summons requiring the defendant to show cause within 30 days from the date of service of summons as to why an order in favour of the plaintiff should not be made.<sup>79</sup> After giving both parties an opportunity to be heard, the tribunal will make an order as it thinks fit "to meet the ends of justice".<sup>80</sup> If it determines that a debt is owed to the plaintiff the Presiding Officer will issue a certificate based on his order to the Recovery Officer, empowering him to recover

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75 *Narasimham Committee Report on The Financial Systems*, 1991, Standard Book Company, New Delhi, 1992, 60

76 Act No.5 of 1993

77 Section 3

78 Section 10 - A presiding officer must be a judge, or qualified to be a judge or held office as a presiding officer of a tribunal for at least 3 years.

79 Section 19(3)

80 Section 19(4)

the amount of debt specified in the certificate.<sup>81</sup> The Recovery Officer will then proceed to recover the certified debt, either by attaching and selling the movable or immovable property of the debtor, arresting and detaining the debtor in prison, or appointing a receiver to manage the movable or immovable properties of the debtor.<sup>82</sup>

If a party is aggrieved by the order made by the Tribunal he can appeal against that decision within 45 days of the date on which the order was made to the Appellate Tribunal.<sup>83</sup> Where the defendant is the aggrieved party and seeking an appeal, he must first deposit in the Appellate Tribunal seventy five per cent of the amount of the debt determined by the tribunal in order to have the appeal entertained.<sup>84</sup> After giving both parties an opportunity of being heard, the Appellate Tribunal will make an order confirming, modifying or setting aside the order made by the Debt Recovery Tribunal.<sup>85</sup>

There are some obvious shortcomings in the statute that may pose problems in the future if the legislation is not suitably amended. First, the Central Government has taken upon itself too much responsibility in the administration of the tribunal. For example, in addition to appointing the Presiding Officer, it is also responsible for appointing the Recovery Officer and *all other employees* (emphasis added) of a tribunal.<sup>86</sup> To take over the responsibility of providing staff for the tribunal is unnecessary, because such matters can easily be delegated to the Presiding Officer, particularly when Central Government administration is riddled with red tape and bureaucracy. It has already been said that the largest single factor in the accumulation of case backlog in the High Courts is

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81 Section 19(7)

82 Section 25

83 Section 20(3)

84 Section 21

85 Section 20(4)

86 Section 7(1)

the enormous delay in making appointments to fill vacancies.<sup>87</sup> If this is a significant problem in the judicial system and a similar bureaucratic procedure is followed to appoint staff to the tribunals, before long it will adversely affect the smooth running of the tribunal.

Although the primary object of the statute is to provide banks and financial institutions with an expeditious recovery procedure, it is silent on two important aspects relating to time. The Act does not provide with a time limit for the service of a summons on the defendant. Once summons are effected, it requires the defendant to show cause within thirty days<sup>88</sup> from the date the application was filed with the tribunal.<sup>89</sup> After taking into account the practical difficulties that a lender may face to serve summons a realistic time limit must be set out otherwise all the defaulting borrower will have to do is avoid the process server until this period has passed. The second matter is that the Act is silent as to the outcome of a case if these time limits are exceeded. Failure to comply with time limits must not have the effect of extinguishing the debt.<sup>90</sup>

The RDBF Act applies to Indian banks and financial institutions and foreign institutions that the Central government may specify by notification after having regard to its business activity and the area of its operation in India.<sup>91</sup> All other financial institutions, i.e. foreign banks with no Indian presence must pursue recovery actions in the ordinary civil courts. If a loan is granted by a consortium of lenders both local and foreign, the

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87 *124th Report of the Law Commission on The High Court Arrears : A Fresh look*, Government of India, Delhi, 1988, Chapter II

88 Section 19(3)

89 Section 19(8)

90 Similar technical problems are reported in the rules of the Special Courts established in Bangladesh. See Husain, A., *Country Report for Bangladesh*, Presented at the Symposium on Legal issues in Debt Recovery, Credit and Security (Unpublished), Manila, 1993, 28-29

91 Sections 2(d),(e),(f),(h)

debt recovery under the RDBF Act involves a "two track" system.<sup>92</sup> Local banks will have the option of seeking a remedy under the RDBF Act while the foreign banks will have to pursue their claim in the ordinary civil courts. It is indeed difficult to follow why foreign banks are barred from bringing actions under this statute, particularly when such lenders are entitled to bring actions under Order 37 of the Civil procedure Code that provides for summary procedure.

Another significant omission in the Act is that it does not provide for determining complex issues such as set-offs or counterclaims. If the tribunal cannot adjudicate on such matters the defendants would be barred from using these as defences.

A question that also needs clarification is whether a property subject to a mortgage that is attached and sold by a recovery officer enforcing an order of the tribunal is in fact sold free of encumbrances. Usually, to enforce such security, a decree from a civil court under the Transfer of Property Act is required.<sup>93</sup>

A recovery officer is a public servant and is not required to have any training legal or otherwise to carry out his duties, which includes not only the power to attach and sell the property of the defendant but also to arrest the defendant and detain him in prison.<sup>94</sup> The Act considers the arrest and detention of defaulters in prison a "mode of recovery of debts."<sup>95</sup> Arresting defaulting borrowers cannot be described as a mode of debt recovery but only a punishment for default.<sup>96</sup> Given that the primary objective of the Act is

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92 Shroff, V., *The Indian Debt Recovery Act* (1995) 10 JIBL 29

93 Goyle, L., *The Transfer Of Property Act of 1882*, Eastern Book Company, Calcutta, 1991, 226-235

94 Section 25; The Indian and Sri Lankan Civil Procedure Codes also provides for this remedy. India- Order XXI Rules 37-41, Sri Lanka- Section 298

95 Section 25(b)

96 In countries like the United Kingdom and Australia, the imprisonment of debtors was abolished in the nineteenth century. (1869 and 1843 respectively) However, in Canada, statutes permitting the imprisonment of debtors are still in force. Tilbury, M., et al, *Remedies : Commentary and Materials*, 2nd Ed., Law Book Company, Sydney, 1993,

debt recovery, the inclusion of penal provisions is not necessary. Perhaps it can be argued that including such provisions would be a deterrent to other defaulters or it is a mode of coercing debtors to pay their debts, but it is indeed an antiquated approach to debt recovery. From a lenders point, recognising ordinary commercial risk as a criminal risk to make debt recovery more effective is an impractical and pointless exercise. For example in Bolivia, non payment of debts is a criminal offence, consequently, one third of the people in jail in La Paz are there for “debt related crimes.” 60% of them are women. The Bolivian experience has shown that sending people to jail as a remedy for debt recovery has failed completely.<sup>97</sup>

In *Jolly George Varghese v Bank of Cochin*<sup>98</sup> the judgement debtors appealed against a court warrant that directed the arrest and detention in a prison of the debtors, on account of non payment of a debt due to the respondent bank. The question before the Indian Supreme Court was whether such deprivation of liberty was illegal. The Court having examined the provisions of Order XXI Rule 37 and Section 51 of the Civil Procedure Code<sup>99</sup> as well as Article 21 of the Constitution<sup>100</sup> and Article 11 of the International Covenant on Civil and Political Rights, directed the case to be re-adjudicated, and emphasised that the question might arise some day as to whether the proviso to section 51, read with Order XXI Rule 37 (CPC), was in excess of the constitutional mandate contained in Article 21. Article 11 of the International Covenant

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824-826; Dunlop, C., *Creditor-Debtor Law in Canada*, 2nd Ed., Carsewell, Ontario, 1995, Chapter 5

97 *How Legal Restrictions on Collateral Limit Access to Credit in Bolivia*, World Bank, Washington DC, 1994, ii

98 (1990) AIR (SC)470

99 Section 51 of the Civil Procedure Code grants power to the Court to enforce a decree and one of the modes is by arresting and detaining the defendant, and Order XXI Rule 37 of the Code sets out the procedure to follow when detaining a person. Chaturvedi, R., *B. N. Banerjee On Law of Execution*, 4th Ed., Law Book Co., Allahabad, 1994, 417 - 425

100 Article 21 of the Constitution guarantees the protection of life and personal liberty of a

on Civil and Political Rights, as quoted in the *Jolly Varghese* case reads:

"No one shall be imprisoned merely on the ground of inability to fulfil a contractual obligation."

Thus, it is clear that international law frowns upon holding debtors in prison and limiting their personal freedom. It is important to take note of such views when legislation is being drafted so that it commands the respect that is properly due.

An important aspect of a civil suit is the award of interest on a debt during the litigation period and also the costs involved. Both these issues have not been addressed in the new statute and the law must be amended so that a presiding officer can make such orders.

#### 5.5.2 *The Sri Lankan Debt Recovery (Special Provisions) Act of 1990*

Until 1990, there were only two types of actions a creditor could file to recover its overdue debts. They are: the regular procedure and the summary procedure under the Civil Procedure Code. In 1985, Wimalaratne Committee reviewed the problems relating to poor debt recovery and recommended a number of amendments to the Civil Procedure Code. The committee went on to say that action based on the suggested amendments alone was not adequate to meet the legitimate needs of the lending community and that it was opportune to enact legislation providing for a special debt recovery procedure. The World Bank also made it a precondition that the country's debt recovery laws must be liberalised if it were to grant further loans to the government,<sup>101</sup> thus forcing the government in an indirect way to accelerate the implementation of the recommendations. Finally, in 1990, despite strong opposition from the Bar Association, the Debt Recovery (Special Provisions) Act No. 2 of 1990 was enacted to facilitate the expeditious recovery

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101 Rt. Hon. De Mel, R., (Then Minister of Finance), Hansard, 25 November 1987, 898 - 899

of debts by banks. According to the provisions of the Debt Recovery (Special Provisions) Act No. 2 of 1990<sup>102</sup> a bank can institute action to recover an overdue debt by presenting a plaint to the District Court.<sup>103</sup> On presenting a plaint, the bank must file an affidavit to the effect that the sum claimed is lawfully due to it and produce a copy of the legal instrument sued upon or relied on.<sup>104</sup> If the court is satisfied of the contents of the affidavit, and the legal instrument sued upon is duly registered and not open to suspicion by erasure or an alteration on the face of it, the court will enter a decree nisi for a sum not exceeding the debt due together with interest and costs. The decree nisi is thereafter served on the defendant. In the first instance the decree will be served by registered post. The “Advice of Delivery” of the registered letter in which the decree was sent, or an acknowledgement of the receipt of the decree nisi by the defendant, or a statement of the service endorsed on the duplicate of the decree nisi shall be sufficient proof that the decree nisi was effectively served on the defendant.<sup>105</sup>

Section 6 does not allow a defendant to appear or show cause in court against the decree nisi unless leave to do so has been first obtained from court. If such an application is made by the defendant, supported by an affidavit which deals specifically with the plaintiff's claim, together with a clear concise defence to the claim, and the facts that are relied upon to support the defence, court may grant leave to defend the claim after giving the defendant an opportunity to be heard. Leave may be granted only if the amount stated in the decree nisi is paid into court or if the court is satisfied there is a defence that is prima facie sustainable. Where court has granted leave to appear and show cause, the trial is conducted under the Civil Procedure Code. If the defendant fails to appear, or after

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102 Amended by the Debt Recovery (Special Provisions) (Amendment) Act, No 9 of 1994

103 Section 3

104 Section 4

105 Section 5A



appearing is unable to show cause or his application to obtain leave to defend the claim is refused, the decree nisi will be made absolute.

Where a defendant appears in court and admits liability and agrees to pay the outstanding debt in instalments the Court must minute this fact and make the decree absolute. An order absolute is deemed to be a writ of execution, duly issued to the Fiscal. The execution of this writ will not be stayed, notwithstanding anything to the contrary.<sup>106</sup>

To qualify for access to the new debt recovery procedure the sum alleged to be in default must be more than Rs. 150,000/=. The effect of this provision will be that lenders will be discouraged from granting loans below this amount and in effect discriminate against the small-scale borrowers. If this limitation is continued, the end result will be that the majority of honest small-scale borrowers will be denied access to credit because of the threat posed to banks by a handful of defaulters. Surprisingly, a similar constraint is not seen in the Recovery of Loans by Banks (Special Provisions) Act which applies to the recovery of bank loans secured by mortgages over movable and immovable property. This inconsistency of treatment is difficult to follow. The new debt recovery laws have yet to make a positive impact on the existing crisis in the legal system faced by Sri Lankan lenders.<sup>107</sup> Although the lenders have been given additional powers and the right to recover their debts, in practice the laws introduced for their benefit do not appear to be as effective as originally anticipated. For example, the Peoples' Bank had filed a debt recovery suit under the new Act in December 1990 and the case was at the stage of filing an answer in March 1992.<sup>108</sup>

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106 Section 13(1)

107 The Justice Minister has announced plans to reform the country's archaic legal system to allow speedy settlement of commercial disputes. Jayasinghe, A., *Sri Lanka To Reform Laws*, Financial Times, 11.10.1996

108 Interview with Mr. Gunasekera, P., Chief Legal Officer, Peoples' Bank, at the Bank Head Quarters, Colombo, on 14 May 1997.

One reason is that the judicial attitude towards the new laws is one of indifference. It has been reported that judges still treat cases filed under the regular procedure and under the new debt recovery laws alike. Where actions are filed under the new procedure, judges tend to grant leave to a defendant to appear and defend the case simply when a defendant files an affidavit seeking leave to appeal. The stringent requirements of section 6 of the Debt Recovery Act are simply not taken into account.

Another reason is that the court staff is still unfamiliar with the procedural steps that have to be followed after the decree nisi is granted. Under the new debt recovery procedure a final decree is also treated as a writ of execution but courts tend to follow the execution procedure of a regular action using the special forms provided in the Civil Procedure Code.

It is clear that the problems encountered by lenders cannot be resolved only by enacting effective laws. There is a vital need to provide suitable training to judges who will deal with commercial cases.<sup>109</sup> In addition, the administrative staff in the courts and the fiscal department must be made aware of the new procedure, and required to comply with the procedure. It is equally important to encourage the members of the legal profession to act in the spirit of the enacted reforms.

## 5.6 WINDING UP IN INDIA, SRI LANKA AND MALAYSIA

Strictly speaking, winding up is not, or should not be used, as a means of debt recovery, as it is an insolvency procedure. Its objective is to ensure the *pari passu* treatment of all unsecured creditors. It has been said however, that the basis of insolvency law is far more complex and that these laws are treated by the "trading community as an

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109 *Third Interim Report Of The Committee On Debt Recovery Legislation*, Government Printing Department, Colombo, 1992, xi

important instrument in the process of debt recovery.”<sup>110</sup> The threat of insolvency proceedings is an effective weapon to persuade a defaulting debtor to pay its debts and thus it could be used as a sanction of last resort.

The Insolvency Acts of India, namely, the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 restrict the jurisdiction of the Indian Insolvency Courts to making an order of adjudication against insolvent "debtors".<sup>111</sup> The term "debtor" does not include corporations therefore, when a company is insolvent the winding up and distribution of assets is regulated by the Companies Act, 1956. The Indian Companies Act is based on the English Companies Act of 1948 and the provisions relating to winding up are identical in all material aspects to the English Act.<sup>112</sup> In Sri Lanka, the winding up of companies is regulated by the Companies Act, 1982.<sup>113</sup> As in India, the Sri Lankan Companies Act is also based on its English counterpart of 1948 and the winding up provisions are almost identical. It must be noted however, that the amendments made to the English statute after 1948 have not been incorporated into the Companies Acts in both these countries. The Malaysian Companies Act, 1965 (Revised 1973) regulates the winding up of insolvent companies.<sup>114</sup> In terms of concept and statutory language once again the English Insolvency laws have influenced the Malaysian laws. Since in all three jurisdictions the English Companies Act of 1948 has been followed when the respective companies statutes were enacted, it is best to discuss the winding up provisions applicable

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110 *Report of the Review Committee on Insolvency Law and Practice*, Cmnd 8558, HMSO, London, 1982, 62 (The Cork Report)

111 Veena, C., *The Law of Insolvency*, 2nd Ed., C. Jaminadas & Co., Bombay, 1997, 1-2

112 Rustomji, K., *Company Law*, 3rd Ed., University Book Agency, Allahabad, 1991, Part VII

113 Wickremasinghe, K., *Company Law In Sri Lanka*, 2nd Ed., Aitken Spence Printing (Pvt.) Ltd., Colombo, 1992, Chapter R

114 Pillai, P., *Source Book of Singapore & Malaysian Company Law*, 2nd Ed., Butterworths, Singapore, 1986, Chapter XIII; Lee Mei Pheng, *Banking Law*, Butterworths (Asia), Hong Kong, 1995, 304-305

to these countries together, so that unnecessary repetition can be avoided.

In all three countries, the inability to pay debts is a ground for petitioning for a company to be wound up. Thus a lending bank has a statutory right to present a winding up petition to court if its indebtedness has fallen due and not been repaid by a debtor company.<sup>115</sup> Where such a petition has been presented to wind up a company on the ground that it is unable to pay its debts, the court must be satisfied that the debt is currently due for payment. For example, when a company arranges with a bank to operate on an over draft, there is an express or implied understanding that repayment is due on demand, but usually, such a facility would continue to operate indefinitely with it being periodically renewed. This type of debt does not come within the meaning of a debt due for repayment. Similarly, debts arising out of commercial transactions that are entered into on the basis of credit will not be due for payment until the credit period expires.

The court will not make an order to wind up a company if the debt in question is being disputed. The debt owed to the company must be clear, valid in law, unimpeachable and indisputable.<sup>116</sup> If the debt is being disputed, it is important to establish whether the dispute is bona fide or not, and for this, the conduct of the parties, their motives, character of pleas and peculiarities of the case in question all become relevant. In *Asa Teknik (M) Sdn Bhd v Cyga Sdn Bhd*<sup>117</sup> the petitioner applied to have a company wound up claiming it was unable to pay its debts. The evidence showed that the debt was being strongly disputed and that the petitioner had earlier filed an action in the High Court to recover the sum in question. Subsequently, the petitioner applied for summary judgement but the application was dismissed by the Senior Registrar and the petitioner then filed a notice discontinuing the civil action and negotiated for a settlement. When no settlement was

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<sup>115</sup> India - Section 433, Sri Lanka - Section 162, & Malaysia - Section 218(1)

<sup>116</sup> *In Re Yashodan Chit Fund Ltd.*, (1980) 50 Comp. Cases 356

reached a petition was filed for the company to be wound up. Striking out the winding up petition the court held that, on the evidence presented there was a bona fide dispute as to the amount owing and that the petitioner's actions showed that they were acts calculated to circumvent the normal course of procedure and was an abuse of the process.

The circumstances in which a company is deemed unable to pay its debts are:

- (1) If it has not complied with a statutory demand,<sup>118</sup> or
- (2) If execution of a judgement or other process issued against the company is returned unsatisfied,<sup>119</sup> or
- (3) It is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due and in determining whether a company is unable to pay its debts the court shall take into account the companies contingent and prospective liabilities.<sup>120</sup>

In India and Sri Lanka, if a company is indebted in a sum of Rs.500/= and in Malaysia RM. 500/= and a statutory demand is served on the company, and it is not satisfied within three weeks, the company is deemed unable to pay its debts.<sup>121</sup> Non compliance with a statutory demand is adequate evidence that a company is unable to pay its debts and a winding up petition can be presented on that ground. Default in payment

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117 [1989] 2 MLJ 423

118 India - Section 434(a) ; Sri Lanka - Section 163(1) ; Malaysia - Section 218(2)a The statutory demand procedure should not be used as a means of debt recovery. A statutory demand is one of the methods by which a winding up is triggered. And if the creditor has no intention of continuing with the winding up in the event of the demand not being complied with it is an abuse of the insolvency process, because such a demand could be the basis of a "legal threat". A creditor who uses the statutory demand procedure must be willing to incur the considerable expense and pursue winding up proceedings if the demand fails to promote payment which it often will.

119 India - Section 434(b) ; Sri Lanka - Section 163(2) ; Malaysia - Section 218(2)b

120 India - Section 434(c) ; Sri Lanka - Section 163(3) ; Malaysia - Section 218(2)c

121 Neglect to meet a demand of a creditor gives rise to a rebuttable presumption that the company is unable to pay its debts. See *Securicor (M) Sdn Bhd v Universal Cars Sdn Bhd* [1985] 1 MLJ 84

alone is sufficient evidence of inability to pay debts,<sup>122</sup> but if the default was the result of the debtor company disputing the debt then, it cannot be said that the company is deemed insolvent.<sup>123</sup>

Where a statutory demand for an undisputed debt has not been complied with and/or execution of a judgement or other process against the company is returned unsatisfied, it may be because the debtor company is unable to meet its current demands made upon it. These are generally known as instances of "commercial insolvency"<sup>124</sup> but this does not necessarily mean that the company is insolvent, because it may have assets that have not been realised. If on the other hand, the company's assets after realisation are still inadequate to meet its liabilities then clearly the company is insolvent. In *Hotel Royal Ltd. Bhd. v Tina Travel & Agencies Sdn Bhd (No.2)*<sup>125</sup> the debtor company was not able to settle the amount due on a judgement obtained in an earlier action and, consequently, the creditor company petitioned the company to be wound up under section 218(1)e of the Malaysian Companies Act. The debtor company applied to court to set aside the petition arguing that it had realisable assets that would cover the amount due. The High Court of Malaysia held that section 218(1)e must be construed to mean "insolvency in the commercial sense," i.e. inability to meet current demands irrespective of whether the company is possessed of assets which, if realised would enable it to discharge its liabilities in full, and that the test of insolvency did not depend on the existence of the company's realisable assets. It may be queried why it is possible to wind up a company that is insolvent in a *commercial sense* without having to establish that it is in fact insolvent in

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122 *Cornhill Insurance plc. v Improvement Services Ltd.* [1986] 1 WLR 114, 118; *Taylor's Industrial Flooring Ltd v M & H Plant Hire (Manchester) Ltd.* [1990] BCLC 216; *Re Bill Hennessey Associates Ltd.*, [1992] BCC 386

123 *New Era Furnishers (P) Ltd. v Indo Continental Hotels & Resorts Ltd.* (1990) 68 Comp. Cases 208 (Raj)

124 Rustomji, K., *Company Law*, 3rd Ed., University Book Agency, Allahbad, 1991, 1216

the *absolute sense*. The reason is that creditors usually do not have easy access to the company's records to determine for themselves the state of the debtor company's financial position, and it is therefore difficult to establish whether a company is insolvent or not in the absolute sense. McPherson J explained it as follows,

“The phrase ‘unable to pay its debts’ is susceptible to two interpretations. One meaning which may properly be attached to it is that a company is unable to pay its debts if it is shown to be financially insolvent in the sense that its liabilities exceed its assets. But to require proof of this in every case would impose upon an applicant the *often near-impossible task of establishing the true financial position of the company* and the weight of authority undoubtedly supports the view that the primary meaning of the phrase is insolvency in the commercial sense - that is inability to meet current demands irrespective of whether the company is possessed of assets which, if realised, would enable it to discharge its liabilities in full.<sup>126</sup> (emphasis added)

It may be asked how effective the winding up of a debtor company would be to a lender, as an effective method of recovering its money. Winding up is a collective process and the fundamental principle governing it is that of *pari passu* treatment of unsecured creditors. The use of winding up as a means of recovery is therefore, not very beneficial to a banker in the position of an unsecured creditor, because after claims are allowed on the basis that they do not belong to the company (i.e. trust property; goods supplied under a retention of title clause; assets subject to liens), and preferential creditors are paid, what generally remains for the unsecured creditors is pitifully small or nothing at all. It would be rarely, therefore, that banks would resort to winding up of a company where its primary intention is to recover its debts.

There may, however, be circumstances where winding up is the best or perhaps the only remedy available to a lender. If a bank has reasonable grounds to believe that the debtor company has diminished its assets by granting fraudulent preferences,<sup>127</sup> or created

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125 [1990] 1 MLJ 21

126 O'Donovan, J., (Ed) *McPherson's Law of Company Liquidations*, 3rd Ed., Law Book Company, Sydney, 54

127 India - Section 531; Sri Lanka - Section 254; Malaysia - Section 293

floating charges in the run up to insolvency,<sup>128</sup> winding up may be the only way under which the bank can hope to swell the assets available for distribution by having these transactions set aside. Unlike the statutory provisions in the United Kingdom, the Indian and Sri Lankan Companies Acts do not provide for the avoidance of transactions at an undervalue, extortionate credit transactions and transactions to defraud creditors which can be used to swell the assets of the insolvent company.<sup>129</sup> In Malaysia, the Act gives authority to a liquidator to recover property, business or undertaking that has been sold to or acquired by a company for an undervalue within two years before the commencement of winding up and the liquidator may recover any amount by which the value of the property exceeded the cash consideration of the transaction.<sup>130</sup> Winding up with this objective would be beneficial, provided that the bank has no skeletons in its own closet.

#### 5.7 RECEIVERSHIP IN INDIA, SRI LANKA AND MALAYSIA

In addition to recognising a privately appointed receiver under a debenture, the law in India, Sri Lanka and Malaysia also provides for a receiver and manager to be appointed by court.<sup>131</sup> Such an officer represents neither the debenture holder nor the debtor company, he is an officer of the court and will carry out his duties in accordance with the order appointing him. As Lord Romilly said in *Ames v Birkenhead Docks*

*Trustees:*

"There is no question but that this court will not permit a receiver appointed by its authority and who is therefore its officer, to be interfered with or dispossessed of the property he is directed to receive, by any one...."<sup>132</sup>

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128 India - Section 534; Sri Lanka - Section 255; Malaysia - Section 294

129 See the United Kingdom Insolvency Act 1986, Sections 238, 423 and 244 respectively

130 Section 295

131 India - Sections 137(1) & 424 of the Companies Act; Sri Lanka - Sections 98(1) & 382(1) of the Companies Act; Malaysia - Section 186(1)

132 (1855) Beave. 332 at 353 (52 ER 630, 638)



A court appointed receiver has a fiduciary duty to all the creditors<sup>133</sup> and must manage and operate the debtor's business as though it were his own.<sup>134</sup> In this part the discussion will be on court appointed receivers and their role in the recovery of debts due to unsecured creditors. Privately appointed receivers and managers will not be considered because their primary task is to recover debts by enforcing the security taken by the secured creditor that appointed him.

In India, a creditor can apply to court under Order 40 Rule 1 of the Civil Procedure Code to have a receiver appointed to a debtor company's property when ever it appears to be "just and convenient" to do so. A receiver cannot be appointed merely because it is "just." It must also be convenient. In other words, the appointment will be made only if it is practicable and the interests of justice require it.<sup>135</sup> The phrase just and convenient gives the court discretion to appoint receivers for a wide range of purposes.

The Civil Procedure Code in Sri Lanka also provides for the appointment of a receiver by court if it appears that a receiver is necessary to restore, preserve, manage or take better custody of a debtor company's movable or immovable property.<sup>136</sup> The Sri Lankan statutory provision is more restrictive than its Indian counterpart in that a court can appoint a receiver only for the purposes described above. A simple amendment to section 671 on the lines of Order 40 of the Indian Civil Procedure Code will make court appointed receivership more effective and available to a wider range of persons interested in a debtor company's properties.

In Malaysia, court may appoint a receiver for the purpose of preserving the

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133 *Satyanarayan Banerjee v Kalyani Prasad* (1945) AC 387

134 Bennette, F., *Receivership*, Carswell, Toronto, 1985, 118

135 Section 51(d) of the Civil Procedure Code; Chaturvedi, R., *Banerjee on Law of Execution*, 4th Ed., The Law Book Co., Allahabad, 1994, 425-428; Pillai, P., and Nair, P., *Law of Receivers*, 3rd Ed., Law Book Co., Allahabad, 1988, Chapter xxvii

136 Section 671

debtors assets, or to assist in the enforcement of creditor's rights.<sup>137</sup> A debtor's property may have to be protected if there is a dead lock or mismanagement in a company, or if the creditors are concerned that their security is in jeopardy.<sup>138</sup> Creditors may also apply for the appointment of a receiver by way of equitable execution. Court will make such an appointment if it is just and convenient to do so.<sup>139</sup>

Equitable execution is a process where a court appoints a receiver to assist a judgement creditor to obtain payment of a debt which he has failed to recover by ordinary execution proceedings.<sup>140</sup> Prior to the court appointing a receiver, it must be satisfied that the debtor has equitable interest in the property, it is capable of assignment<sup>141</sup> and it is not possible to carry out normal execution proceedings.<sup>142</sup> A judgement debtor may find executing the judgement impossible for a number of reasons, some legal others practical. Ordinary execution proceedings will not be possible if a third party holds a lien over the debtor's property. Similarly, if the debt cannot be recovered through garnishee proceedings because the debt cannot be ascertained or it is not yet due and owing the court may appoint a receiver. As a more practical problem, legal execution will be difficult if the debtor is evading execution proceedings, for example by avoiding the service of the writ of attachment. Where it can be proved in court that the judgement debtor is attempting to remove the assets of the company or concealing other debts that are due to it by setting up

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137 Abdulla, S., *Corporate Receivership : The Law and Practice in Malaysia and Singapore*, Butterworths (Asia), Malaysia, 1997; Kamar, S., *Powers and Duties of Corporate Receivers and Managers*, Malayan Law Journal Sdn Bhd, Kuala Lumpur, 1996, 2-3

138 RCH- Order 30

139 RCH - Order 51

140 The term "Equitable Execution" may be misleading. If a judgement creditor is unable to execute a judgement through the normal process, the court may grant him *equitable relief* by appointing a receiver.

141 Picarda, H., *The Law Relating to Receivers, Managers and Administrators*, 2nd Ed., 1990, Butterworths, London, 309, 319-320

142 *Harris v Beauchamp Brothers* [1984] 1 QB 801

trusts, profit sharing schemes and entering into inter company transactions court will appoint a receiver by way of equitable execution. In practice however, Malaysian courts rarely appoint receivers by way of equitable execution.<sup>143</sup>

## 5.8 DELAYS IN THE COURTS

The people of India and Sri Lanka are fast losing their confidence in the courts and are disillusioned with the legal systems because of the undue delay and backlog of cases in the courts. Of course in litigation, some amount of delay is inherent to the process but it becomes a problem when the delay is "undue."<sup>144</sup> Compared with India and Sri Lanka, in Malaysia, the delays experienced in the courts are not excessive. Lenders do not consider the delays experienced in the courts a significant problem yet.<sup>145</sup> The following discussion will therefore concentrate on court delays in India and Sri Lanka.

Both in India and Sri Lanka, on average, if a case is heard by the Supreme Court by the time a decision is granted, parties would have spent about 12 years in litigation.<sup>146</sup> Unfortunately, detailed statistics are not available for both countries and it is impossible to state exact figures, but, the important point to note is that the delays are excessive and as a result the problems of court delays and backlog of pending cases are acute.<sup>147</sup>

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143 Ibid.

144 Delay occurs when in the given circumstances it becomes "unacceptable." What may be an excessive length between the commencement and the disposal of one case may not necessarily be excessive for another type of case, but delay becomes undue when a lapse of time occurs where in the circumstances is considerable and not essential to a just resolution of the case. Cranston, R., et al, *Delays and Efficiency in Civil Litigation*, Canberra Publishing and Printing Co., Fyshwick, 1985, 4

145 Interview with Mr Ng Chih Kaye, Head, Special Credits, Credit Control Division, at May Bank Head Quarters, Kuala Lumpur, on 30th May 1997.

146 India - Baxi, U., *Crisis of the Indian Legal System*, Vikas, New Delhi, 1982, Chapter 3, Sri Lanka - Jayawardena, N., *Debt Recovery Legislation Parts I-III*, Ceylon Daily News, 18-20 August 1989

147 In both countries India and Sri Lanka, a number of committees have studied the problem of court delays. The most recent are, *124th Report of the Law Commission of India on The High Court Arrears : A Fresh Look*, Government of India, Delhi, 1988 and *Report*

In fact, it would not be inaccurate to say that the court systems are almost collapsing due to the high number of pending cases which have created a severe backlog in the courts. Justice Bhagawati of India in his speech on Law Day on 26 November 1986 observed:

"I am pained to observe that the judicial system in the country is almost on the verge of collapse. These are strong words I am using, but it is with considerable anguish that I say so. Our adjudicatory system is creaking under the weight of arrears...

We may now refer to the question of the mounting arrears and long delays that take place in the disposal of cases and the inability of the courts to cope with fresh institutions. This, I believe is the greatest threat posed to the rule of law and the institution of court....

A bare glance at the statement of various types of cases pending in different courts and of the duration for which those cases have been pending is enough to show the enormity of the problem."<sup>148</sup>

#### 5.8.1 *Causes of Delay and Backlog of Cases*

Most of the reasons causing delays are common to India and Sri Lanka. The legislature, judges, lawyers, and the court officials involved in the judicial administration are all responsible for this crisis situation in the courts.<sup>149</sup>

##### *Ill drafted legislation passed by the legislature*

It is well known that both in India and Sri Lanka laws are often hastily passed in parliament, and as a result they are some times ill drafted and full of errors. For example, the new debt recovery laws that were passed in the Sri Lankan Parliament in 1990 were fraught with drafting errors, and so was the Indian Recovery of Debts Due to Banks and

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*of the Sri Lanka Law's Delay and Legal Culture Committee, Aitken Spence Printing (Pte) Ltd., Colombo, 1985*

148 Quoted in the 125th Report of The Law Commission of India on The Supreme Court : A Fresh Look, Government of India, Delhi, 1988, 7

149 Siwach, J., "Delay in Justice in India" in Grover, V.,(Ed) Courts and Political Process in India, Deep and Deep Publications, New Delhi, 1989, 328; Jayawardene, N., *Debt Recovery Legislation Parts I-III*, Sri Lanka Daily News of 18th-20th of August 1989

Financial Institutions Act of 1993. Ill-drafted legislation engenders litigation, thus increasing the number of cases that are filed.<sup>150</sup> It is indeed optimistic to speculate that the legislature would stop passing laws in this hurried manner, nevertheless, it must be emphasised that properly drafted laws do reduce litigation.<sup>151</sup>

### *Practices of Judges and Lawyers*

Judges and lawyers are also responsible for the present crisis. With regard to judges, one contributory factor is that the number of judges is insufficient to deal with the pending cases. In India, the situation this has created is so alarming that the Supreme Court once observed:

"This Court has no time even to dispose of cases which have to be decided by it alone and by no other authority. Large numbers of cases are pending from 10 to 15 years. Even if no new case is filed in this Court hereafter, *with the present strength of Judges*, it may take more than 15 years to dispose of all the pending cases."<sup>152</sup> (Emphasis added)

But it is worth questioning whether simply appointing judges is an answer to this problem. It is difficult to generalise and conclude that if judge strength is increased it would provide more judge time. If however, after proper investigations are carried out it can be concluded that a country has too few judges, then, additional appointments may be made.

The Law Commission of India found that the two most important factors contributing for the backlog of cases were inadequate judge strength, and the long delay in

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150 On the other hand, if the statute is riddled with drafting errors people will avoid filing cases under that statute. For example, in Sri Lanka, the new debt recovery acts that were passed in 1990 for speedy debt recovery was not used by banks because some of the statutory provisions caused practical difficulties which were in fact errors. The necessary amendments were introduced in 1994.

151 Siwach writing on delays in the courts in India says, "If like a command given in the army, the text is simple and straight forward, then the amount of litigation would be less. Hence, efforts should be made to draft the laws properly." Siwach, J., *"Delay in Justice in India"* in Grover, V., (Ed) *Courts and Political Process in India*, Deep and Deep Publications, New Delhi, 1989, 328, 337

filling vacancies in the High Court which results in the loss of judge days.<sup>153</sup> It is indeed surprising why vacancies cannot be filled quickly, particularly when the process of justice is already painfully slow. Political interference may be the answer.

Delay occurs not only when the number of judges is deficient, but also when the judges are inefficient. It is a judge's professional duty to do what he reasonably can do to equip himself to discharge his duties with a high degree of competence.<sup>154</sup> If a judge is incompetent, inefficient or lacks the required skills to adjudicate,<sup>155</sup> it will only be natural if in the court where he sits, there is a backlog of cases.

It is equally important that, judges firmly control the manner in which cases are conducted. According to the former Indian Chief Justice Sikiri,

"[t]he counsel should be heard fully, but if the point is barely arguable or the point or authority cited is irrelevant a judge should politely ask the counsel to proceed to the next point. Times have come when the time of the court must be rationed like a scarce essential commodity. The judges and counsels must keep in mind the thousands of litigants who are impatiently waiting for their cases to be heard."<sup>156</sup>

Another cause that irritates litigants is when judges grant adjournments on

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152 *P.N. Kumar and Another v Municipal Corporation of Delhi* [1987] 4 SCC 609, 610

153 *124th Report of The Law Commission of India on The High Court Arrears Committee : A Fresh Look*, Government of India, Delhi, 1988, 18

154 Sir Bingham, T., "*Judicial Ethics*" in Cranston, R., (Ed), *Legal Ethics and Professional Responsibility*, Clarendon Press, Oxford, 1995, 37

155 In the Sri Lankan case, *Hotel Galaxy (Pvt) Ltd. v Mercantile Hotels Management Ltd.* former Chief Justice Sharvananda said,

"It is regrettable that the District Judge did not address his mind to the legal question whether on the facts pleaded by the plaintiff, the defendants could, in law, be restrained by an injunction or enjoining order. As *ex parte* enjoining order and orders for interim injunctions may work grave hardship and injustice to parties who have not been heard, grave responsibility rests on a judge to exercise the discretion vested in him, judicially, having due regard to the law before he grants an *ex parte* application for the issue of an interim injunction or enjoins the defendant in terms of section 662 of the Civil Procedure Code. Such reliefs should be granted only after being satisfied that both the facts averred by the plaintiff and the law applicable thereto call urgently for them." (1987) 1 SLR 5, 22

156 Quoted in Siwach, J., "*Delay in Justice in India*" in Grover, V.,(Ed) *Courts and Political Process in India*, Deep and Deep Publications, New Delhi, 1989, 328, 341

applications made by the debtor on trivial grounds. For example, in Sri Lanka, it is common for a lawyer to ask for an adjournment on "personal grounds". The reason being that the lawyer is unable to be present because he had to appear in another case elsewhere.

An additional District Judge of Sri Lanka once observed,

"The prevailing procedure in the original civil courts of our country appears to be designed to encourage the delinquent debtor. This procedure as well as the existing machinery, gives him more than ample opportunity to adopt dilatory tactics and postpone the evil day. .... a hirer would apply for at least two postponements. He would tender at least one medical certificate to have the trial postponed...."<sup>157</sup>

"Weak judges" who do not control cases firmly also bear the responsibility if a backlog of cases builds up in the courts they preside over. An illustrative example of this problem is seen in a debt recovery suit filed in Sri Lanka. The case was filed in May 1980, answer was filed in January 1981 and the trial was fixed for 1st December 1981. The trial was postponed nine times and the reasons for postponement was not recorded except on two occasions. The reasons recorded were that the "plaintiff was not ready" and "several old cases had been fixed for trial."<sup>158</sup> The tenth trial date was 22 February 1985, which was over three years from the original trial date. The advantages of summary procedure may be best felt at such times. Proper judicial training may also help judges who tend to be lenient when conducting cases.

Not only judges, but lawyers also carry responsibility for the existing delays in the courts. If a lawyer's workload is high, it entails delays in the courts. Lawyers that are known to be successful are more in demand than others. Successful lawyers are

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157 Additional Judge L. Abeysekera, *"Debt Recovery, Some Observations"* Paper Presented at the Seminar on Debt Recovery, on 27 September 1986 in Colombo, 1. However, Judge Abeysekera informed the author that this comment was made prior to the new debt recovery laws were enacted, and the position may have improved due to the new laws. Interview with Mr Abeysekera by telephone (Retired High Court Judge, now Chairman of the Sri Lanka Legal Aid Commission) on 30 October 1998.

158 *Report of the Sri Lanka Law's Delay and Legal Culture Committee*, Aitken Spence Printing (Pte) Ltd., Colombo, 1985, 19

predisposed to retaining cases, thus accumulating a personal backlog of cases which in turn creates a backlog in the courts. In India and Sri Lanka this situation arises among successful lawyers.

The time taken for trials to be conducted is too long. Lawyers are often ill prepared, and ill organised, and end up with unnecessarily lengthy arguments, which takes up valuable court time. Long arguments are like a "chronic disease" and may even be described as oral quibbling. As a part of radical reform to speed up court delays, the former Indian Chief Justice Krishna Iyer suggested the practice in the American Supreme Court which requires all arguments to be set out in writing. Amidst much opposition from the Supreme Court Bar Council,<sup>159</sup> the Supreme Court amended its rules so that written submissions could be filed.<sup>160</sup>

Not only do defence lawyers give spurious reasons to have trials postponed, even when the trial eventually commences they take up frivolous defences, and the time of the court is consequently spent in going into these, one by one, which is a purposeless use of judicial time.<sup>161</sup> To deny service of summons or argue that the contract is unconscionable and should not be enforced is common practice. It is therefore the duty of the trial judge to determine if these defences are genuine or not.

Economic considerations also influence professional practices.<sup>162</sup> The legal

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159 The Bar Council described the change to the rules as an unhealthy departure in the dispensation of justice. It argued that "the right of audience in a court of law is a substantial right and deprivation and curtailment of it was a negation of justice. See Times of India, 8 June 1975, 7

160 In the United Kingdom, in response to the increasing case load in the Court of Appeal, it considered whether it should follow the practice of the United States Supreme Court if in the future it is to resolve appeals without unacceptable delay. No reported decision on the matter has yet been taken. Lord Justice Leggatt, *Future of the Oral Tradition in the Court of Appeal* (1995) 14 CJQ 11

161 Cranston, R., *Credit, Security And Debt Recovery: Laws Role in Reform in Asia and The Pacific* in Norton, J., and Andenas, M., (Eds.) *Emerging Financial Markets and Secured Transactions*, Kluwer Law International, London, 244-245

162 Zuckerman, A., *Reform in the Shadow of Lawyers' Interests*, in Zuckerman, A., &



profession is no different. Some lawyers tend to prolong the proceedings longer than necessary, just to earn more fees. This is very obvious in India<sup>163</sup> and the position in Sri Lanka the same.<sup>164</sup> Dr Charles Hanson writing on the reform of the legal profession in the United Kingdom observed that the "legal profession is a deeply entrenched vested interest."<sup>165</sup> One cannot always draw parallels but in this instance drawing a parallel to the Indian and Sri Lankan lawyers may be justified.

Sir Owen Dixon once told his law students at the University of Melbourne,

"To be a good lawyer is difficult. To master the law is impossible. But I should have thought that the first rule of conduct for counsel, the first and paramount ethical rule was to do his best to acquire such a knowledge of the law that he really knows what he is doing when he stands between his client and the court and advises for or against entering the temple of justice"<sup>166</sup>

What Sir Dixon expects of a lawyer is the ideal. Every client has the right to expect his lawyer to carry out his duties in an honest and responsible manner, and to conduct the case in such a manner that he gains the respect of the judges before whom he is appearing. Unfortunately, in India and Sri Lanka, the overall standards of lawyering have deteriorated to such an extent that the profession is in disrepute and the people are disillusioned with their lawyers.

It is now clear that the practices and attitudes of individual judges and lawyers

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Cranston, R., *Reform of Civil Procedure : Essays on "Access to Justice"*, Oxford University Press, New York, 1995, 64

163 The Law Commission observed,

The profession cannot only have privileges and no obligations. It is time therefore to take a first step to prescribe the floor and ceiling in fees. The organised Bar must have a prescribed administration department where clients can go, pay the prescribed fee and seek assistance of a lawyer."

*131st Report of the Law Commission of India on The Role of the Legal Profession in the Administration of Justice*, Government of India , Delhi, 1988, 20

164 Jayawardena, N., *Debt Recovery Legislation : Eliminating Inordinate Delays in Debt Recovery*, Part II, Published in the Ceylon Daily News of 19 August 1989.

165 Hanson, C., *Reform of the Legal Profession : The Biggest Bang of All* (1989) 9 Economic Affairs 23

166 Sir Thomas Bingham, *Judicial Ethics*, in Cranston, R., (Ed), *Legal Ethics and*

are significant contributory factors to the problem of delays and high backlog in India and Sri Lanka. Then, the next question that arises is what can possibly be done to overcome this unsatisfactory situation? "Strong Judges" are essential.<sup>167</sup> Judges must be seen to control their cases firmly so that unnecessary and long arguments of counsel are curtailed, frivolous defences filed by the lawyers are disregarded, and cases should be adjourned only on valid grounds.<sup>168</sup>

Another related issue is that in both countries good lawyers are not joining the judiciary because of the low salaries that are being paid to judges.<sup>169</sup> Successful lawyers can earn much more than judges, therefore resources must be allocated to remunerate judges adequately so that good lawyers will consider a judicial career.

Those researching delays in the developed countries have shown that there is a link between formal litigation procedure and the practice of the lawyers, sometimes referred to the "local legal culture." In fact, informal relationships between all the parties involved in litigation must not be ignored because they are the key to most of the problems.<sup>170</sup> An obvious solution would then be to suggest remedies involving the proper training, discipline and professional ethics of lawyers and judges. How effective this remedy would be in practice in countries like India and Sri Lanka in the present circumstances is uncertain. It is not suggested that professional training and legal ethics

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Professional Responsibility, Clarendon press, Oxford, 1995, 37

167 In the United Kingdom, the Lord Chief Justice has directed judges sitting at first instance to control the trial time table by using their discretion to limit discovery, length of oral submissions, the time allowed for the examination and cross-examination of witnesses, the issues on which to be addressed, reading aloud from documents and authorities. Practice Direction of 24 January 1998

168 *David De Silva v Ramanathan Chettiar* (1964) 65 NLR 409, per Basnayake CJ at 411

169 *77th Report Of The Law Commission of India on Delay and Arrears in Trial Courts*, Government of India, Delhi, 1978, 53-54

170 Scott, I., *Case-flow Management in the Trial Courts*, in A., Zuckerman & Cranston, R., *Reform of Civil Procedure : Essays on "Access to Justice"*, Oxford University Press, New York, 1995, 4

are less valued, but whether "self interested" lawyers can be effectively influenced by it is uncertain.

To consider a workable solution, the problem could be approached in two ways. First, sanctions can be introduced, which means that the litigation process will be identified with having characteristics of a commanding process. Second, a less dictatorial approach can be adopted whereby a consensus between judges and lawyers is arrived at with the common objective of achieving the best possible result for both parties. To put it in Scott's words, "we are all in this together so lets do the best we can." <sup>171</sup>

Sanctions will always work where training fails. For India and Sri Lanka, the former approach is more suitable. Although this may appear to be rather draconian, it is only realistic that remedies appropriate to solve the existing crisis are suggested. As one author who carried out a study of the legal system in a developing country in Asia observed:

"The way legal processes are handled in developing countries... has little to do with the way the formal legal system operates. Studying the formal system alone will provide little insight into the nature of the actual legal system."<sup>172</sup>

In both countries, the overall standard of lawyering has fallen because "self interest" reigns over "clients' interests." The quality of judges has also dropped. The entire legal system has fallen into disrepute not only due to the backlog and court delays but also due to the corruption and high litigation charges clients have to pay. In this chaotic climate expecting consensus between judges and lawyers is unrealistic. It is for these reasons that a solution must be found with sanctions as its basis. The second method may be effective in different circumstances from those presently prevailing in India and Sri Lanka.

Procedural sanctions may consist of orders for costs, charging of additional court

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171 Ibid, 23

172 Gray, C., *Legal Process & Economic Development: A Case Study of Indonesia*, The World Bank, Washington D.C., 1989, 36, See the discussion on "Formal Models" at 7-13

fees and fines. The sanctions must be fair and be proportionate when applied. It is also important that the sanctions are clearly set out so that it will not become the basis for contention in the future. For example in the United Kingdom , it has been reported that court delays have occurred because of the manner in which lawyers conduct their cases. To combat the problem Lord Chief Justice Taylor has issued a practice direction which states inter alia,

“Failure by practitioners to conduct cases economically will be visited by appropriate orders for costs, including wasted costs orders.”<sup>173</sup>

Guidance may be taken from the rules laid down by the Master of the Rolls in *Ridehalgh v Horsefield* as to how wasted cost orders should be dealt with.<sup>174</sup>

#### *Practices of Court Officials*

Judges and lawyers are not the only people to be blamed for the delay and backlog of cases. Court officials are also responsible for tardy administration. It is a sad situation, nevertheless true that corruption is rife among court officials and the malfunctioning of the court system is mainly due to "deliberate omissions." A typical example of this is when files that are in the record room "disappear" on the date of the trial. In both countries, there are grave deficiencies in the fiscal service. Service of summons and writs, and the execution of decrees are highly unsatisfactory. This situation has arisen due to a number of reasons; corruption among process servers, lack of staff, lethargic attitude of process servers towards their duties and lack of alternative modes of service to compete with, are some examples.<sup>175</sup>

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173 Practice Direction Issued by the Lord chief Justice on 24 January 1998; Hodge, H., *An End to Court Delays?* (1995) 94 Law Society Gazette 14

174 [1994] 3 All ER 848, 849

175 Although summons could be served by registered post, it was never used due to a number of deficiencies in the Civil Procedure Codes. In Sri Lanka however, the Civil Procedure Code was amended in 1990 allowing for summons to be sent by registered post in suits filed to recover liquid claims. See sections 705A & 705B. The Debt Recovery (Special Provisions)(Amendment) Act of 1994 allows service of decree nisi ordinarily to be served

This depressing situation may be remedied if process servers were remunerated differently. An attachment of wages procedure may prove to be useful.<sup>176</sup> In addition to their basic salary, if a percentage to be decided upon could be added every time the process server succeeds in serving summons, writs etc. it could well be an incentive to work rather than the taking of bribes from litigants. A more extreme solution would be to set up a system whereby reputable firms and companies are licensed by court to provide a service to serve summons and notices, and also to execute decrees.<sup>177</sup> It would be of utmost importance that the persons employed by these firms are competent, responsible and of high integrity, for example, former defence personnel. Another aspect of this is where lawyers are permitted to employ "private process servers" who would hopefully be more effective because of the personal interest which would be taken to have service carried out. Private process servers must be accountable, either to the company or to the individual lawyer employing them, who in turn, must bear the responsibility of any abuses of the court process, say by filing false reports. If they were found guilty, the employers should be subject to heavy penalties. If there were a proven record of malpractice by the process servers, the licence of the firm employing them must be withdrawn, and where they are hired by lawyers, they should face disciplinary action by court.

Delays in courts may be caused by a number of reasons, some are peculiar to a particular case, and others are more general. In this discussion emphasis was given to the

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by registered post. Section 4; In India - Order 5 Rule 19A

176 The Attachment of Earnings Act, 1971 of the United Kingdom can be used as a model for this purpose. Wilson, M., and Ford, J., *Recovering Debt : The Effectiveness of Attachment of Earnings?* (1992) 11 CJQ 363

177 For example, in Sweden, enforcing of judgements are carried out by a specialist establishment judgements. called the "Enforcement Service" (kronofogdemyndigheten) which has no connection to with the courts. Judgements are delivered to the "Enforcement Service" which effectively enforces the judgements. Houghton, A., and Atkinson, N., *Guide to Insolvency Law in Europe*, 2nd Ed., CCH International, Bicester, 1993, 301

general reasons and it can be concluded that the primary cause of delays in the legal systems in India and Sri Lanka are not the statutory procedures that govern litigation, but the persons that function within the system.

## 5.9 CONCLUSION

It was noted at the outset that the debt recovery crisis continues to have a wide spread negative impact on economic growth in most developing countries. This is the situation in India, and Sri Lanka.<sup>178</sup> In Malaysia, whilst it may not be at a crisis, the recovery process is not as quick and efficient as it could be.<sup>179</sup> In India and Sri Lanka the magnitude of the problem now threatens the very existence of the lending institutions operating there. The causes of the problem lie in the shortcomings in the laws governing debt recovery, and in the inadequacies of the prevailing judicial system.

In India and Sri Lanka, in spite of special legislation which provides for speedier debt recovery, the recovery procedure most widely used by lenders is still the ordinary or regular action under the Civil Procedure Code. In Malaysia, debt recovery cases must be filed under the Sub-Ordinate Court Rules and the High Court Rules, because there are no special laws to assist lenders to recover overdue debts. Both in India and Sri Lanka, summary procedure has not been used extensively due to a number of limitations in the law. In Malaysia however, if the lender is confident that the debt is indisputable, a summary action can be filed against the debtor.

The overall picture that emerges when studying the procedural laws governing

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<sup>178</sup> India - Shroff, C., *India Country Report*, Presented at the Asian Development Bank Symposium on Debt Recovery, Credit and Security. (Unpublished), Manila, 1993; Sri Lanka - *Report of the Wimalaratne Committee on the Law and Practice of Debt Recovery*, Sarvodaya Vishva Lekha, Ratmalana, 1985

<sup>179</sup> Interview with Mr. M. Ismail, Senior Partner, Ismail & Co., on 30 May 1997; Chen Kah Leng, *Country Report for Malaysia*, Presented at the Asian Development Bank Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished),

ordinary debt recovery actions in India, is different to that in Sri Lanka. As the Indian Law Commission in its 14th report stated:

" A good deal of the criticism against the procedural laws as the cause of delays when carefully analysed will show that justice is delayed not so much by any defects or technicalities in the prescribed procedure as by it's faulty application or by failure to apply it."<sup>180</sup>

The situation is more complicated in Sri Lanka. The Common Law of the country is Roman Dutch Law but English Law applies to all maritime and commercial matters.<sup>181</sup>

Consequently, much confusion has arisen as to the applicable law in commercial disputes.<sup>182</sup> In 1985, the Wimalaratne Committee took the view that:

“[c]oncept, hitherto uncritically accepted and born of past experience and no longer relevant but yet continue to find expression in outmoded legal procedures, should undergo important and purposeful changes. The aim should be to transform these concepts in order to achieve the essential economic result and the necessary social purpose that recognised institutions, engaged in the business of trading in money as purveyors of credit, are assured that the corresponding debt can be recovered speedily by recourse to court action in the case of need.”<sup>183</sup>

The new debt recovery procedures introduced in the two countries have not produced the anticipated results. The RDBF Act was enacted, primarily to provide justice without delay to banks and financial institutions by providing for the expeditious adjudication of debt recovery suits and the recovery of debts due to them. At the time the Act came in to force, the government specified that ten debt recovery tribunals will be set up, but so far only five tribunals have been established, in New Delhi, Ahamedabad,

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Manila, 1993

180 *14th Report of the Law Commission on Reform of Judicial Administration*, Vol. I, Government of India, Delhi, 1958, 262-263

181 Sections 2 & 3 of the Civil Law Ordinance No. 5 of 1852

182 In *Bank of Ceylon v Kulatilleke* it was decided that the doctrine of conversion should be recognised as part of English Law relating to "Banks and Banking". But later in *Daniel Silva v Johannis Appuhamy*, the Supreme Court disapproved of this decision and held that the English doctrine of conversion does not apply to Ceylon. (1957) 59 NLR 189; (1966) 67 NLR 457

183 *Report of the Committee on the Law and Practice Relating to Debt Recovery*, Sarvodaya Vishva Lekha, Ratmalana, 1985, 12

Bangalore, Jaipur and Calcutta. It has been reported that the tribunals are not functioning effectively due to diverse legal actions filed against the recovery process.<sup>184</sup> A notable case is the action filed by the Bar Association of Delhi challenging the validity of the Act.<sup>185</sup> The High Court has ruled that the Act is unconstitutional as it erodes the independence of the judiciary. It has also ruled that the Act is irrational, discriminatory, unreasonable, and arbitrary and is "hit" by Article 14 of the constitution which provides for equality before the law. As long as public interest litigation cases are filed challenging the validity of the Act, and judges continue to make rulings that support these petitions, the RDBF Act will remain non-effective. Meanwhile, the backlog of pending cases in the courts will continue to rise and justice will be denied to all the litigating parties.<sup>186</sup>

It may be noted that in Pakistan, the special courts established to hear claims appear to be working well.<sup>187</sup> Similarly, Bangladesh enacted a Financial Loan Courts Act which established special commercial courts where lenders could file debt recovery suits against defaulting borrowers. The progress made in these courts are highly favourable.<sup>188</sup> It is not being suggested that because it has worked well in one jurisdiction it must be so in another, but there may be important lessons to learn from the Pakistan and Bangladeshi experiences.

The Indian RDBF Act has its own flaws. This is mainly due to poor drafting of the statute which leaves a number of issues inadequately dealt with and some issues not

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184 Shah, S., *India - Debt Recovery Tribunal* (1996) 11 JIBL N.51; Narayanan, R., and Shah, V., *Debt Recovery Tribunals* (1995) 66 Journal of The Indian Institute of Bankers 140, 143

185 *Delhi High Court Bar Association v Union of India* [1995] AIR (Delhi) 323

186 At present there are 15 lakh of cases filed by the public sector banks and more than 1000 cases filed by the financial institutions pending in various courts in India. Rs. 6000 crores are due to the banks and 400 crores to the financial institutions: Shah, S., *India Debt Recovery Tribunal*, (1996) 11 JIBL N52

187 Kabraji, K., "*Country Report for Pakistan*" Presented at the Asian Development Bank Symposium on Debt Recovery, Credit and Security, (Unpublished) Manila, 1993, 70-74



being addressed at all. If amendments to the statute are introduced to address these defects, it would be a very effective piece of legislation because the primary objective of the statute and its key functions must be commended as a useful tool to solving a problem that is putting the entire legal system in India into disrepute and chaos.

In Sri Lanka, the Debt Recovery (Special Provisions) Act No.2 of 1990 was far from being a water tight piece of legislation that could effectively deal with the existing practices in the courts and related administrative bodies like the Fiscal Department. Several shortcomings in the new legislation were obvious, and in 1991 the government appointed another commission to examine the laws relating to debt recovery and report on any amendments that may be considered necessary.<sup>189</sup> In 1994, most of the amendments suggested by the Commission were implemented by enacting the Debt Recovery (Special Provisions)(Amendment) Act.

Banks and other financial institutions in India and Sri Lanka have rarely used winding up as a method of debt recovery.<sup>190</sup> In Sri Lanka, there are hardly any reported cases, which is an indication that courts have not had an opportunity to express their views on this matter. In India, courts have set themselves against making winding up orders if the ground for the petition is “inability to pay debts.” Indian judges frown upon using winding up as a pressure tactic or with an ulterior motive. In *Kanchananganga Chemical Industries v M/S Mysore Chipboards Ltd.*, court ruled that non-compliance with a statutory demand is not adequate to show that the debtor is insolvent in the commercial sense.<sup>191</sup> The court made such a ruling despite section 433(c) of the Act which states that

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188 *Government and Development*, World Bank, Washington DC, 1992, 37

189 *3rd Report of the Presidential Commission on Banking and Finance on Debt Recovery Legislation*, Department of Government Printing, Colombo, 1992

190 Interview with Mr. D. Hettiarachchi, Deputy Registrar of Companies, at the office of the Registrar of Companies, Colombo, on 13 may 1997.

191 (1995) 3 All India Banking Law Judgments 421, Reported in Kalra, J., et al, *All India*

non-compliance of a statutory demand is a ground to determine inability to pay debts.

A completely different practice is seen in Malaysia. In a recent survey carried out on the insolvency laws of six Asian jurisdictions, the insolvency laws of Malaysia were reported to be very pro creditor. Threatening with insolvency proceedings as a pressure tactic was considered quite normal amongst bankers. As one leading insolvency lawyer said:

"Banks choose bankruptcy as a method of debt collection because the threat of insolvency is an effective tactic. Whilst not the fastest technique, it is a common and effective legal tactic in the recovery of debts. Banks see it as good management and there are no cultural reasons why this technique should not be used."<sup>192</sup>

The laws on court receivership in India and Malaysia are in line with those of most common law countries.<sup>193</sup> In Sri Lanka, the law is neither satisfactory nor effective, and needs to be amended so that it provides a wider discretionary power to court to make such orders. If the words "just and convenient" are substituted for the words "to be necessary for the restoration, preservation, or better custody or management of any property, movable or immovable, the subject of an action or sequestration" the law would be more effective and in keeping with the current practice and judicial thinking of other common law countries which have shown that, if necessary, court appointed receivers could play an effective role in the debt recovery process.

It is evident from the preceding discussion that the problems of debt recovery may be said to threaten the rule of law in India and Sri Lanka. The legal systems have become inefficient and unpredictable. The courts are usually overworked, and dispute

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*Banking Law Digest (1987-1995)*, Punjab Law Agency, Chandigarh, 1996, 354

192 Tomasic, R., et al, *Insolvency Law Administration and Culture In Six Asian Legal Systems* (1995) 6 Australian Corporate Law Journal 249

193 Benette, F., *Receivership*, Carswell, Toronto, 1985, O'Donovan, J., *Company Receivers and Managers*, Law Book Company, Sydney, 1981, & Lightman, G., & Moss, G., *Law of Receivers of Companies*, 2nd Ed, Sweet and Maxwell, London, 1994

resolution takes a long time. The courts lack proper facilities, and the persons involved in the administration of justice require training. Corruption is rife amongst low wage earners employed in the courts and the fiscal departments.

It is of utmost importance that the existing court administration is overhauled so that cases are dealt with expeditiously and at a reasonable cost to the plaintiff. Proper law enforcement agencies should be also created to carry out effectively the decisions of the courts. To streamline judicial administration, sanctions as well as direct and indirect incentive schemes must be introduced. Sanctions would go some way to ensuring when conformity to existing laws and practices are required. Incentives may be productive of better results. Changes are important, but these alone would have little effect if judges and lawyers do not co-operate and act according to the spirit of the changes that are made.

## CHAPTER SIX

### *FINAL OBSERVATIONS AND RECOMMENDATIONS*

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- 6.1 *TENSIONS BETWEEN MARKET REFORMS AND THE LAW*
  - 6.1.1 *Greater Access to Foreign Lenders*
  - 6.1.2 *Protecting the Rights of Creditors*
  - 6.1.3 *A Modern Insolvency Law*
  - 6.1.4 *Lending and Security*
  - 6.2 *LAW AND PRACTICE OF CREDIT ALLOCATION AND DEBT RECOVERY*
  - 6.2.1 *Credit Allocation and Debt Recovery: The Reform Context*
  - 6.2.2 *Credit Allocation and Loan Supervision*
  - 6.2.3 *Enforcement of Security*
  - 6.2.4 *Debt Recovery Through The Courts*
  - 6.3 *CONCLUSIONS*
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#### 6.1 *TENSIONS BETWEEN MARKET REFORMS AND THE LAW*

The laws of a country must reflect the policies it wishes to promote. When a country engages in political, social and economic change, there is a pressing need to modify and reform its legal system to reflect these changes arises.<sup>1</sup> While this applies to almost every country, it is particularly significant in countries which are developing or changing to market economies. The existing laws in these countries may be inappropriate, or be inconsistent with the liberal economic policies which are being pursued. In some instances there may be uncertainty as to the application of laws and their enforcement, thereby destroying the incentive to comply with the laws. It may also

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<sup>1</sup> Legal reforms cannot be confined to the drafting and enactment of appropriate legislation alone. The changes made to the legislation must be supported by administrative and judicial reforms which will ensure that the legislative changes will be implemented and enforced. It is equally important that reforms to the legislation and institutional building are implemented together so that each reinforces the other. Efforts at reforming legislation will fail if the institutions required to implement the laws are ineffective. *The World Bank and Legal Technical Assistance*, The World Bank, Washington DC, 1995, 7 ; Weald, T., and Gunderson, J., *Legislative Reform in Transition Economies : Western Transplants - a Short Cut to Social Market Status?* (1994) 43 *International and Comparative Law Quarterly* 346, 361

create situations that foster corruption, raise transaction costs and discourage trade and investment.<sup>2</sup> In addition, these laws may not facilitate the grant of credit and debt recovery.

In India, Sri Lanka and Malaysia, laws that facilitate free market economic policies are being actively promoted, by the introduction of new laws as well as the amendment of existing legislation. Nevertheless, a number of laws remain inconsistent with the economic policies that are being pursued. The following sections give some examples - laws hinder access to justice to foreign lenders thus treating foreign and local lenders unequally, laws restricts creditor rights and insolvency laws are antiquated.

#### 6.1.1 *Greater Access to Foreign Lenders*

To attract foreign lenders, a country should have a stable political, economic and legal environment.<sup>3</sup> Lenders must be confident that there are no political risks, such as sudden nationalisation or confiscation of undertakings. They must also be assured that there would be no restrictions on transfer of remittances of interest and capital. Inflation must be seen to be tightly controlled. Currency conversions must be possible, and there should be no foreign exchange controls. Lenders will also consider in their lending decisions, the stability of the legal system. They will look at whether the legal system allows lenders' rights to be enforced and whether disputes that arise can be resolved expeditiously. In all legal and other proceedings, foreign and local parties must be treated equally. If foreigners are treated differently, private lenders will seriously consider this as a potential problem. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 in India provides a good example.

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<sup>2</sup> *Governance: The World Bank's Experience*, The World Bank, Washington DC, 1994, 23

<sup>3</sup> Demesai, D., *Financing Projects in Emerging Markets* (1994) 13 International

The Recovery of Debts Due to Banks and Financial Institutions Act was enacted for the purpose of adjudicating expeditiously, disputes relating to debts owed to Indian banks and financial institutions. According to the definitions in the Act, a bank or financial institution to which the Act applies falls into one of two categories: (1) a bank or financial institution incorporated under Indian law or (2) a foreign bank that carries on banking business in India and financial institutions the Reserve Bank of India has officially recognised under the Act.<sup>4</sup> Foreign banks with no Indian presence are not designated under the Act.

The fact that some foreign banks are not covered by the Act may have potentially adverse consequences for lenders employing co-financing structures in India.<sup>5</sup> If a lending group consists of exclusively foreign lenders, they must have recourse to the Indian Courts. If however, a lending group involves Indian and non Indian lenders which are not covered by the Debt Recovery Act, in the event of default some lenders would have recourse to the debt recovery tribunals while the others would have access only to the Indian Courts. The Act does not recognise that modern commercial bank lending can involve several lenders, both local and foreign. It appears to have been drafted on the assumption that the debt is due from a single borrower to a single lender. An amendment to the Act allowing all banks and financial institutions irrespective of their area of operation to have access to the debt recovery tribunals is

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Financial Law Review, (Supplement-July) 8-9

4 A “bank” means, a banking company, a corresponding new bank, State Bank of India, a subsidiary bank or a regional rural bank. (section 2(d) ) A “banking company” is defined as having the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949 which states, “ a banking company means any company which *transacts the business of banking in India*”.(emphasis added) The Act defines a “financial institution” as a public financial institution incorporated under the provisions of the Companies Act, 1956 or such other institution the Central Government may, having regard to its business activity and *the area of operation in India*, by notification, specify.(emphasis added) (section 2(h) )

5 Shroff, C., *Country Report for India, (Unpublished)*, Presented at the ADB Symposium

necessary. There appears to be no significant hurdle to such an amendment, particularly when the Civil Procedure Code allows summary procedure to be used without such discrimination.

### 6.1.2 *Protecting the Rights of Creditors*

A country aiming to achieve economic growth by promoting private investment must secure creditors' rights. Unless creditors' rights are recognised and protected, lenders would be compelled to adopt restrictive lending policies. This may lead to high interest rates, and low volumes of lending that directly affect the economic growth of a country.

Security improves the position of lenders in two circumstances.<sup>6</sup> First, if a debtor becomes insolvent, a lender as a holder of valid real estate security<sup>7</sup> will be in a position of pre-eminent advantage. As a holder of such security, a lender is entitled to enforce its rights of realisation of that security independently, and thereby stand outside the insolvency process. If security had not been taken, a lender would be regarded as an unsecured creditor, and would have to prove a claim in the insolvency proceedings, for a pro rata settlement of its debt.<sup>8</sup>

Second, if a borrower defaults payment, a lender who has taken security would be able to recoup his losses by enforcing the security. In some jurisdictions, however, secured creditors find it difficult to enforce their rights due to intervening laws. For

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on Legal Issues in Debt Recovery, Credit and Security, Manila, 1993, 74

<sup>6</sup> Everett, D., and McCracken, S., *Banking and Financial Institutions Law*, 3rd Ed., Serendip Publications, Sydney, 1988, 305-306

<sup>7</sup> It is assumed that all the required formalities have been fulfilled including proper registration.

<sup>8</sup> In an insolvency situation, two opposing principles can be seen, namely; the equal treatment of classes of creditors and recognition of the rights of secured creditors. Pro creditor countries recognise both principles.

example, in India, the Sick Industrial Companies (Special Provisions) Act and effectively blocks secured creditors from enforcing their security in the event the debtor becomes “sick” or “potentially sick.”

According to section 22 of the Act, notwithstanding any law, if an inquiry were pending or a rehabilitation scheme were under consideration, proceedings for the winding up of the company or execution, distress or the like against any of the properties of the industrial company, or the appointment of a receiver is prohibited except with the consent of the Board, or, the Appellate Authority. Clearly, as a matter of law, section 22 blocks the exercise by creditors of their rights of security. The suspension imposed on secured creditors is not time bound. Consequently, creditors will be unable to exercise their rights until a rehabilitation scheme either succeeds or fails which in practice may take several years.

The Indian courts have also shown a great keenness to protect the rights of debtor companies and their employees, and have shown little concern for creditors' rights.<sup>9</sup> In *Workers of M/S Rohtas Industries Ltd. v M/S Rohtas Industries Ltd.*, the Supreme Court in exercising its writ jurisdiction ruled against a bank enforcing its rights to pledged goods, and in favour of the claims of the company's employees to back wages.

“So far as the pledge and the priority of the financial institutions are concerned, we have no doubt that they have other sufficient securities and properties of the company and, therefore, if this stock of finished products are sold to meet the basic requirements of the workers, their interests would not be in jeopardy.”<sup>10</sup>

### 6.1.3 *A Modern Insolvency Law*

A modern insolvency law is essential in a market economy. It provides

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<sup>9</sup> *Gram Panchayat v Shree Vallabh Glass Works Ltd* [1990] AIR (SC) 1018; *Navanit R. Kamani v R.R Kamani* [1989] AIR (SC) 9



enterprises that are insolvent with an orderly means of exit from the market. Moreover, enterprises in financial difficulty but potentially viable will be given an opportunity to restructure. Most importantly for present purposes, banks and financial institutions may be able to recover their outstanding loans by threatening reorganisation or insolvency proceedings. It is vital that both liquidation and reorganisation are determined by financial considerations, and not guided by political and social considerations. If the reorganisation of a debtor company appears to be financially viable, then it must be pursued in order to restore its profitability and to maintain its work force in employment. If, however, a reorganisation were not viable, the enterprise must be wound up. Although this is a preferable course of action to take, in many countries winding up of companies are extremely unpopular and there is a distinct preference for rehabilitation. The primary concern is the loss of employment if companies are wound up. This is particularly true in the Asian countries.<sup>11</sup>

In India, the Sick Industrial Companies (Special Provisions) Act was enacted for the purpose of reviving “sick” or “potentially sick” companies by the expeditious enforcement of revival schemes devised by the Board of Industrial and Financial Reconstruction (BIFR).<sup>12</sup> If an industrial company became sick, it is *mandatory* that the directors of the company report this to the BIFR. If the BIFR decides that it is possible for a sick company to be revived it may give time to the sick company to reorganise itself and return to profitability or failing which recommend a rehabilitation programme to be carried out under its direction.<sup>13</sup>

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10 (1987) 2 SCC 588, 590

11 Tomasic, and Little, P., *Insolvency Law and Practice in Asia*, FT Law & Tax Asia Pacific, Hong Kong, 1997, 4

12 Banerjee, G., *Law and Rehabilitation of Sick Industries*, UDH Publishers, Delhi, 1988, 3

13 Section 18

Since the Sick Industries Act was enacted, there has been an increase in the number of sick units as well as outstanding bank credit. As at end March 1987, there were 201,123 industrial companies reported sick by commercial banks, involving a total of 4699 crores in bank credit.<sup>14</sup> By the end of March 1995, the number of sick companies had increased to 270,730 and the total bank funds locked up due to industrial sickness had increased to 12,287 crores.<sup>15</sup>

The statistics indicate that promoting rescues by statutory means does not always succeed. The mandatory nature of such statutory provisions can push more businesses into further difficulties, particularly if the rescue process were time consuming and cumbersome. Rescuing the businesses by way of injecting new bank funds may, in some cases, be more effective.<sup>16</sup> It is not suggested that lenders' rights must be protected, to the total exclusion of a borrower's welfare. Countries like the United Kingdom, Australia and Canada follow liberal economic policies, but laws provide for the rescue of insolvent debtors.<sup>17</sup> An attempt is normally made to facilitate the rescue or rehabilitation of a company before subjecting it to a terminal insolvency procedure. In the U. K, the Bank of England has introduced guidelines known as the "London Approach" to assist banks in their decisions relating to companies with

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14 At the time the Sick Industries Act was enacted, the statistical data available was until the end of March 1987. *Report and Trend of Banking in India*, Reserve Bank of India, Delhi, 1989, 77-78

15 With the liberalising of the economy, the number of industrial companies increased significantly. The number of sick units may also have increased as a result. The important point to note however, is that the Sick Industries Act has not had a major impact on reducing or keeping the numbers steady as they appear to be on the increase. *Report and Trend of Banking in India*, Reserve Bank of India, Delhi, 1997, 46-47, 128, Appendix Table II.17

16 Wood, P., *Remedies and Risk : International Comparisons* in Cranston, R., (Ed.) *Banks and Remedies*, Lloyd's of London Press Ltd., London, 1992, 2

17 The Administration Order Procedure and Company Voluntary Arrangements in the United Kingdom , Insolvency Act, 1986 Pts. I & II; Company Voluntary Arrangements in Australia, Corporations Law (as amended) Pt. 5.3A; Business Proposals in Canada, Bankruptcy and Insolvency Act, Pt. III

financial problems. One of the key features of the “London Approach” is that banks are expected to remain supportive during a debtor’s financial difficulties, and to allow the company to use existing facilities without appointing receivers.<sup>18</sup>

The Sick Industries Act envisages the winding up of a sick company only after the BIFR has formed a final opinion that the company cannot be rehabilitated. According to the Act, a sick company should be wound up in the public interest after all measures to rehabilitate it have been futile.<sup>19</sup> In practice, this provision makes it extremely difficult for the BIFR to prove that a company must be wound up in the “public interest.” Workers will continue to appeal against such decisions on the grounds that there are other methods to save it.

In 1996, the government appointed a working group to re-write the Companies Act, 1956 to facilitate improvement in the Indian corporate sector. It recommended, inter alia, that reference to the BIFR must be made voluntary, so that the debtor company and its creditors are encouraged to settle the debts privately.<sup>20</sup> The overall recommendations are consistent with the present economic policies India is following and are commendable. Critics who defend employee rights say that the entire set of recommendations is a “bundle of conceptual confusions and misconceptions.”<sup>21</sup>

In Sri Lanka, social considerations similar to the ones in India prevent certain enterprises from closing down. The government’s policy on privatisation was presented to its people as “peoplisation.” Under the “peoplisation programme,” certain identified

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18 Kent, P., “*The London Approach*” (1993) 33 Bank of England Quarterly Bulletin 110 The London Approach has been quite effective, but recently some concerns have been reported by lenders. Barratt, J., *Distressed Debt-The Sale of Loan Assets* [1998] 13 JIBL 50, 56; Bird, C., *The London Approach* (1996) 12 Insol. Law & Practice 87-88

19 Section 20(1)

20 *Dealing With Industrial Sickness : Misconceptions of Working Group on Companies Act* (1997) XXII Economic and Political Weekly 934

21 Ibid.

public corporations and government owned business undertakings were converted into public companies<sup>22</sup> and the government ceased to have control over such companies.<sup>23</sup> However, according to the Rehabilitation of Public Enterprises Act, 1996, if the President of the country were of the opinion that in any privatised public enterprise there is, or is likely to be, a *cessation or a substantial reduction in the work of any part of an enterprise, and non employment or retrenchment of a substantial number of workers or the non payment of wages and statutory dues*, the President may order the government to take over the administration and management of the company, including control of all the immovable and movable property of the company.<sup>24</sup>(Emphasis added) The enterprises that are taken over will be managed by a “Competent Authority” that is compelled by law to recommence the business activities of such an enterprise which had ceased to function, restructure it so as to ensure its commercial viability, and infuse the necessary resources to achieve the above objectives.<sup>25</sup> The direct results of these statutory provisions are that the government prevents the closure of public enterprises that were privatised under the peoplisation programme, even if they have proved to be not commercially viable. Protection of employee rights appears to have been given paramount importance.

The present government that is known to be leftist, has nevertheless resolved to continue with the privatisation programme, which was started prior to it taking office in

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22 Conversion of Public Corporations or Government Owned Business Undertakings into Public Companies Act, No. 23 of 1987

23 During the early years of 1990 the peoplisation programme was vigorously promoted, but it later ran into difficulties. The private sector complained that the labour laws were not suited for privatised commercial activities. There are 46 labour laws in operation and the overall effect of these laws tend to create confusion and uncertainty to both employers and employees

24 Section 2. If however, the parliament refuses to approve the order of the President the management of the company will be handed back to the Chairman and the Board of Directors. Section 4 & 5

25 Section 3(4) b,c, & d

1994.<sup>26</sup> Conversely, it has also resolved to maintain the state enterprises that were privatised irrespective of their economic cost. Clinging to the social obligation of protecting the rights of workers by keeping non-viable enterprises open is contrary to the basic concept of a market economy. It will also discourage financial institutions from advancing credit. If market forces have determined that a commercial enterprise is not viable, and attempts to rehabilitate it have failed, it must be closed down. The government must, however, ensure that workers would be provided with fair redundancy packages.

#### 6.1.4 *Lending and Security*

Loan transactions may be secured or unsecured. Lenders will be prepared to grant unsecured loans if the creditworthiness of borrowers sufficiently assures that the loan will be repaid.<sup>27</sup> Most lenders in developing countries however, do not lend without security. Lending institutions demand security as a pre-condition to the granting of credit irrespective of the extent of the risk involved. In some countries, lending institutions have been protected against loan defaults by law, by making security compulsory. For example, the Banking and Financial Institutions Act, 1989 of Malaysia require lending institutions to take security except for small loans.<sup>28</sup>

Bank Negara Malaysia has the power however; to publish an order in the official gazette and permit licensed institutions to grant credit without security to any person, as

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26 *Privatisation, Yes, Peace No*, 22 July 1995, *The Economist* 66-67

27 At one time, international lending was unsecured because taking security was considered to be impractical, but now security is taken in respect of project financings by way of fixed and floating charges over shares, bank accounts, legal assignment of material contracts etc. At the other end of the scale, private moneylenders may grant unsecured loans as informal sanctions ensure repayment.

28 Section 60(1)

long as it does not exceed the aggregate amount set out in the order.<sup>29</sup> At present, licensed institutions are not permitted to grant credit facilities without security for loans exceeding RM 10, 000/= including previous credit granted without security.<sup>30</sup>

The effect of this restrictive legislation is that borrowers trying to secure small and medium loans for their business ventures without substantial fixed assets to offer as security are cut off from accessing institutional credit. As one “foreigner” is reported to have observed, “There are no real bankers in Malaysia. They can only give loans based on collateral.”<sup>31</sup> This is indeed a sweeping statement. It is possible that it is not the lack of willingness on the part of banks to extend credit that restrict lenders, but the express provisions in section 60(1) of BAFIA.

The rationale of taking security is not disputed.<sup>32</sup> If a lender were of the view that security is required because there would be an element of risk involved in lending to a particular borrower, the lender should take security to cover its risks. On the other hand, bankers must have the freedom to grant unsecured loans, if they consider a borrower’s creditworthiness is such, that security would not be necessary. For example, in the case of borrowers managing small and medium scale businesses that are sound and viable and the risk of it becoming insolvent is low, security may not be necessary. Lenders must have the flexibility to appraise a borrower's creditworthiness and make an independent decision as to the requirement of security. If bankers were to grant unsecured loans, their credit appraisal must be carried out to an extremely high standard, where the risk element is assessed as accurately as possible.

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29 Section 60(2)

30 Banking and Financial Institutions (Credit Facilities without Security) (Licensed Finance Companies and Licensed Merchant Banks) Order made on 26 September 1989

31 Devadason, R., *Why are Exciting New Start-ups Finding it Hard to Get Bank Loans?* 16 September 1993 Malaysian Business 3

32 Wood, P., *Comparative Law of Security and Guarantees*, Sweet and Maxwell, London,

## 6.2 *LAW AND PRACTICE OF CREDIT ALLOCATION AND DEBT RECOVERY*

So far in this chapter I have examined laws which are inconsistent with the process of moving towards an open market. But there are steps which have been taken to facilitate economic and financial liberalisation. In India, Sri Lanka and Malaysia privatisation programmes have been launched to promote private and entrepreneurial initiatives. As an important pre requisite to attracting foreign and even domestic investment, deregulation of the financial sectors has also been undertaken. In this section I propose to highlight the various weaknesses in the liberalisation process identified in Chapter Two as well as summarise the state of the law and practice on credit allocation and debt recovery examined in Chapters Three to Five.

### 6.2.1 *Credit Allocation and Debt Recovery: The Reform Context*

Despite the determination of the respective governments of India, Sri Lanka and Malaysia, these emerging markets are not fully liberalised yet. An important cause is that the governments have continued to control interest rates directly, and to direct credit. In India, the Reserve Bank continues to prescribe the maximum rate of interest for deposits up to one year.<sup>33</sup> Further, the interest rate policy for rural lending has not changed. Consequently, banks are required to grant loans to rural borrowers in the priority sectors at concessional interest rates. In order to cover the loss of income due to the charging of concessional interest rates to priority sector borrowers, banks have been directed to charge higher interest rates from non-priority sector borrowers.<sup>34</sup>

In Sri Lanka, under the New Comprehensive Rural Credit Scheme (NCRCS) the

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1995, 3

33 Rangarajan, C., *Banking Sector Reforms: Rationale and Relevance* [1997] Reserve Bank of India Bulletin 41, 43-44

34 In India, this practice is commonly known as cross-subsidisation

government pays an interest subsidy to lending institutions so that they may grant loans to the agricultural sector borrowers at low interest rates. The Central Bank also provides a credit guarantee cover for loans granted under the NCRCS scheme.<sup>35</sup>

Bank Negara Malaysia continues to set a ceiling on interest rates for loans granted to small-scale enterprises under the New Principal Guarantee Scheme (NPGS) of the Credit Guarantee Corporation.<sup>36</sup> Another limitation is that both in India and Malaysia, the Central Banks annually set credit targets that lending institutions must meet. At present, the Reserve Bank of India requires banks to lend 40% of the funds available for lending to the priority sectors. In 1996, Bank Negara Malaysia had directed commercial banks to allocate RM 1 billion to small-scale entrepreneurs under the New Principal Guarantee Scheme. In addition, one half of the allocated quota of funds had to be granted to the Bumiputera community. It also directed commercial banks to lend 30% of their loan funds to the Bumiputera community.<sup>37</sup> The practice of directing credit has now been phased out in Sri Lanka.

### 6.2.2 *Credit Allocation and Loan Supervision*

To develop an effective legal response to the problem of debt recovery, it is essential to shift the focus from court procedures to other areas. An efficient system for the creation and enforcement of security is therefore crucial. A parallel effort must also be made to reduce the use of security in lending transactions. In India and Sri Lanka, access to credit largely depends on the availability of collateral, irrespective of the

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35 [1995] Central Bank of Sri Lanka Annual Report 127

36 For 1996, the ceiling rate of interest was 2 percentage points above the basic lending rate of the individual banking institutions. [1996] Annual Report of Bank Negara Malaysia 194-195

37 A peculiar feature of Malaysia is that the government actively promotes the economic well being of the bumiputera community, (i.e. the indigenous Malay people) by introducing economic and financial policies that favour these people. [1996] Annual



borrower's credit rating, or any associated credit risk. Lenders are well aware that if there were default, security taken over immovable property cannot be easily realised, yet, they continue to insist on taking land security when loan applications are being considered. In Malaysia, lenders insist on security for small loans, only if there is an element of risk that the borrower may default. It is said however, that some financial institutions, including large banks, require borrowers to issue post dated cheques to cover at least one or two years of the loan instalments.<sup>38</sup> If the loan exceeds RM 10,000/= the law requires banks to take security.

If lenders were prepared to, grant unsecured loans because the creditworthiness of a borrower assures repayment, and, take security from borrowers only to the extent it would cover the risk of non-payment of the loan; at least two important objectives could be achieved. First, borrowers that have been effectively denied credit due to their inability to furnish security will gain access to credit. Second, debt recovery related litigation would be effectively reduced.<sup>39</sup> To reduce the risk of default, lenders may take a number of precautions that will improve their credit protection. In the case of corporate borrowers, lenders must give equal importance to the five requirements generally known among bankers as the five "C"s. They are, character, capacity, capital, collateral and conditions. In addition, developing new credit assessment procedures, such as the "credit scoring system" in the United Kingdom, may benefit both lenders and potential borrowers. The banks will of course have to maintain up-to-date statistics.<sup>40</sup> Credit appraisals must also include interviews, visits to the customer's

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Report of Bank Negara Malaysia 194-195

38 Interview with Mrs. Badariah Sahamid, Banking Law Lecturer, University of Malaya, Kuala Lumpur, on 2 June 1997.

39 Research showed that one of the main causes responsible for delays in debt recovery suits is foreclosure and sale of mortgage property.

40 In the U.K, "credit scoring" is known to be one of the most consistent, accurate and fair

business premises and collecting information from professionals dealing with the customer such as valuers and accountants.

In all three countries, there is room for improvement in loan documentation. The practice of using standard forms for almost all of the loan agreements is not acceptable. If the loan transaction is simple and straight forward, a standard form is adequate as it helps to reduce transaction costs. In all other cases, loan agreements must be drafted, preferably by lawyers, to incorporate the individual terms and conditions of the loan. Properly drafted loan agreements could provide lenders with credit protection or give them influence over borrowers, or control over a loan.<sup>41</sup> Detailed covenants, clearly setting out reporting and monitoring obligations by borrowers, also enhance credit protection to lenders. It is also an effective method of monitoring a borrower's performance after a loan has been granted. Covenants that require a borrower to provide information regarding its financial status would provide lenders with early warning signals of any financial difficulties a borrower may be experiencing.<sup>42</sup>

The importance of monitoring a borrower's performance has been recognised by lenders in India and Malaysia. In India, banks have formulated a "Health Code" and "Service Area Approach" in their effort to supervise loans. The "Health Code" needs to be clarified further, but it has potential to be very effective. In Malaysia, banks monitor borrowers systematically and regularly and as a result, "warning signals" are picked up

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forms of credit assessment. Credit scoring measures the statistical probability that credit will be satisfactorily repaid. Guide to Credit Scoring, Office of Fair Trading, London, 1993; Sweet, P., *Received With Thanks : Special Report on Debt Management* (1995) 116 Accountancy 56-57

41 Day, J., and Taylor, P., *Bankers' Perspective on the Role of Covenants in Debt Contracts* [1996] 5 JIBL 201

42 Day, J., and Taylor, P., *Loan Documentation in the Market for U.K Corporate Debt : Current Practice and Future Prospects* [1997] 1 JIBL 7, 8

quite early.<sup>43</sup> Sri Lankan lenders have not given serious attention to this aspect of lending. Inadequate resources and bank staff to carry out monitoring are said to be the main constraints.<sup>44</sup> This is a short-sighted view to take.

### 6.2.3 *Enforcement of Security*

In India, a lender may foreclose or sell immovable property subject to a mortgage only after obtaining a court order. If the parties are not Hindu, Muslim or Buddhist, or a member of any other race, sect, tribe or class specified in the official Gazette, and have executed an English mortgage, the mortgagee has the right to sell the property without intervention of court. This is indeed a strange statutory provision, but an important point that must not be ignored is that the law recognises extra judicial sales, at least in restricted circumstances. When the Transfer of Property Act was enacted in 1882, it was designed to prevent the exploitation of socially backward and low-income groups, rather than to deal with commercial and banking lending. The statutory provisions dealing with mortgages are not appropriate for modern commercial lending transactions, and to persist with these provisions a century or more later would obviously be inappropriate. Two decades ago, The Banking Laws Committee recommended that credit institutions must be given the power of extra judicial sale. In view of the liberal economic policies that are now being pursued by the Government, the implementation of this recommendation would have far reaching benefits to the flow of credit in the country.

If power of extra-judicial sale were to be conferred on banks, section 69 of the Transfer of Property Act would have to be amended. The Sick Industries (Special Provisions) Act would also have to be amended, so that actions under section 22 would

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43 Interview with Mr. Ng Chih Kaye, May Bank Head Quarters, Kuala Lumpur, on 30 May 1997.

44 Interview with Mr. P., Gunasekera, Chief Legal Officer, Peoples' Bank, Peoples' Bank

not interfere with the sale of property subject to a mortgage. The Companies Act, 1956 would also have to be amended to provide that, if a receiver is appointed, any provisional liquidator or subsequently appointed liquidator could not interfere with a sale.

Regarding movable property, banks may take security by way of hypothecation agreements. Sometimes hypothecations are in fact pledges (e.g. key loan arrangements) and in such an event the banks can sell the property without resorting to the court. On the other hand, security taken by way of hypothecation over inventory and stock in trade may constitute an equitable charge. If there is default, the lender will not be able to take possession of the goods and to sell them without first obtaining a court order.<sup>45</sup> For the same reasons as explained earlier, there is no significant reason why the right of extra judicial sale should not be extended to hypothecated goods, provided borrowers are given suitable notice before lenders are entitled to take possession and sell property.

The Indian Companies Act recognises a floating charge as a form of security. A key feature of the floating charge is that it allows the chargee to appoint a receiver by obtaining a court order, or if it is permitted to do so under the debenture creating the charge, without resort to the courts. Although the law recognises a private receiver and his powers to sell the charged property without a court order, Indian banks are reluctant to appoint private receivers and usually apply to court for an order under Order 40 Rule 1 of the Civil Procedure Code. This practice is followed not because the law is unclear, or doubtful, but is largely due to practical difficulties faced by private receivers when

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Head Quarters, Colombo, on 14 May 1997.

45 *State Bank of India v S.B Shah Ali* (1987) 2 Andra Law Times, 470; *Report of the Banking Laws Commission on Personal Property Security Law*, Government of India, 1977, 24-29

property is being seized and sold.<sup>46</sup> Some of the difficulties perceived by lenders are the lack of competent and experienced persons to act as receivers, employee abuse, violence and harassment by labour, reluctance of law enforcing agencies such as the police to assist private receivers in controlling violent behaviour when taking possession of property. On the other hand, a court appointed receiver is respected by the borrower, its employees and third parties, and the police authorities readily give their assistance when required. Clearly, the problem lies not with the legislation but with its implementation.

In Sri Lanka, the right of parate execution was vested with a limited number of state banks until 1990. The Recovery of Loans by Banks (Special Provisions) Act has extended this power to all commercial banks. In a country where litigation costs are high and excessive delays are experienced in the courts it was anticipated that lenders would consider the right of parate a step forward in enforcing security.<sup>47</sup> In practice, banks have not used this power and continue to resort to the courts. The Commission on Banking and Finance observed:

“[A]fter the introduction of the new laws the private commercial banks, with a single exception, have not resorted to the power of parate execution for reasons *which vary from bank to bank, but with the underlying realisation that it is after all not in the interests of the bank to resort to harsh legal measures in a highly competitive banking market.* The Commission hopes that this cautious attitude of the banks will continue to prevail in the interests of a viable economic system where the banks acknowledgedly are the principle lenders. Indiscriminate use of these measures by banks to hasten the process of debt recovery may lead to the creation of a thriving non-institutional, non supervised high interest lending sector with the banking system gradually sidelined.”<sup>48</sup> (Emphasis added)

The Commission’s fears that if the banks were to resort to parate execution they would

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46 Shroff, C., *India Country Report*, Presented at the Symposium on Legal Issues in Debt Recovery, Credit and Security, (Unpublished), Manila, 1993, 47-48

47 Parathalingam, S., *Parate Execution- Step Forward or Backward?*, Paper Presented at the Seminar on Business Law, Colombo, 17 May 1997

48 *Third Interim Report on Debt Recovery Legislation*, Department of Government Printing, Colombo, 1993, 12

be sidelined by non-bank lenders may be unfounded. If the security given were a floating charge, any non-bank lender would find it very difficult to match terms offered by banks. The reticence in the use of parate execution may be because Sri Lankan banks have hardly any experience with floating charges as security for which parate execution is ideally suited. There are several practical difficulties faced by bank officers when taking possession of secured property. The problems are very similar to those experienced by private receivers in India. Section 352 of the Companies Act is also used by defendants to avoid bank seizures.<sup>49</sup> As soon as a debtor gets to know that a resolution has been passed by the bank to sell the secured property, he gets a friendly creditor to file a winding up petition. This effectively stops the bank from taking further action.<sup>50</sup>

The practice of taking a floating charge as an effective form of security has not developed in Sri Lanka. Bankers have hardly taken floating charges, and if such charges have been created, a receiver has never been appointed in the last thirty years.<sup>51</sup> The reasons for the lack of use of floating charges seem to lie in a combination of ignorance of its potential and a lack of expertise in its use. It is indeed ironical that the law provides lenders with effective remedies which the banking community is hesitant to use. It is possible that the bankers and lawyers are still following the Roman Dutch Law principle that a mortgaged property may be sold only after obtaining a court

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49 Section 352 (1) states;

“Where a creditor has issued execution against the goods or lands of a company or has attached any debt due to the company, and the company is subsequently wound up, he shall not be entitled to retain the benefit of the execution or attachment against the liquidator in the winding up of the company unless he has completed the execution or attachment before the date of the commencement of the winding up.”

50 Example - *Re Kandy Weaving Mills*, Case No. 879/96 (In winding up)

51 Interview with Mr. Morawaka, Retired Registrar of Companies, at 200 Darley Road, Colombo, on 8 May 1997.

order.<sup>52</sup> The Sri Lankan courts have also looked upon parate execution with extreme disfavour.<sup>53</sup>

In Malaysia, property may be secured by a statutory charge or lien. The National Land Code sets out two procedures if chargees wish to sell secured land.<sup>54</sup> If land were held under registry title, a court order is required to sell the property. Conversely, if land were held under a land office title, an application must be made to the Land Administrator. Compared with India and Sri Lanka, enforcing a court order is not too difficult. There are inherent problems such as inadequate bailiffs and resistance shown by borrowers but they are not considered to be of grave concern.

Floating charges are recognised in Malaysia and they are frequently taken as security by lenders. Compared with India and Sri Lanka, lenders do not hesitate to appoint receivers if default occurs. The decision to appoint a receiver is taken quickly and the take-over is usually smooth.<sup>55</sup> Until recently, a receiver appointed under a debenture had the power to sell land subject to a charge created under the National Land Code without a court order if the debenture appointing him had conferred upon the chargee a right to sell the property by private treaty.<sup>56</sup> The decision by the Federal Court in *Kimlin Housing Development Sdn. Bhd. v Bumiputra Malaysia Berhad* changed that

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52 Scott, T., & Scott, S., (Eds.) *Wille's Law of Mortgage and Pledge in South Africa*, 3rd Ed., Juta & Co., Ltd., Cape Town, 1987, 203; Lee R. W., *An Introduction To Roman Dutch Law*, 5th Ed., Clarendon Press, Oxford, 1953, 200

53 In *Almeida v De Zoysa Thambiah* J stated,  
"The Roman Dutch law authorities never allowed *Parate Executie* by which a person could take the law into his own hands. This principle has been consistently applied to all transactions" (1966) 68 NLR 517, 519

54 Sections 253-269

55 Interview with Chan Yim Fun, Executive Director Price Waterhouse, Malaysia, Kuala Lumpur, on 29 May 1997. Chan Yim Fun acts as a receiver.

56 *United Malayan Banking Corporation Berhad v Official Receiver and Liquidator of Soon Hup Sdn. Bhd. (in Liquidation)* [1986] 1 MLJ 75 The case was criticised for undermining the purpose of the National Land Code. Puthuchery J., & Nadkarni, N., *UMBC v Soon Hup : Deathknell For Chargor Protection?* [1987] 2 MLJ cxlvii

view when it ruled that the rights and remedies of parties under a statutory charge are set out in the Code, that they are exhaustive and exclusive, and any attempt at contracting out of those rights *unless expressly provided for in the Code* would be void.<sup>57</sup> (emphasis added) Clearly this is the position in Malaysia until the National Land Code states otherwise. All that can be said is that it is up to the legislature to amend the National Land Code to allow for the sale of charged land by private treaty, either by the chargee or by a receiver and manager. A precedent is contained in section 58 of the Real Property Act 1900, of New South Wales, Australia. It may also be useful to amend the Companies Act along the lines of section 420 of the Australian Corporations Law where the powers of a receiver are clearly set out.<sup>58</sup> Legislation in the United Kingdom and New Zealand have also provided general powers a receiver may exercise, in addition to the specific powers conferred upon him by a debenture holder.<sup>59</sup>

#### 6.2.4 Debt Recovery Through The Courts

Speedy debt recovery has been a matter that has been considered in India<sup>60</sup> and Sri Lanka<sup>61</sup> for more than half a century. It has now been established that in these two countries justice is delayed, not because of significant defects in the debt recovery laws, but because of faulty implementation or the failure to implement it. In India, the

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57 *Restriction on Receivers Powers : Special Briefing* (1997) 10 Insolvency Intelligence 78

58 For further precedents, see Insolvency Act, 1986 of the U.K, Schedule 1; Receiverships Act, 1993 of New Zealand

59 Insolvency Act, 1986 of the U.K, Schedule 1; Receiverships Act, 1993 of New Zealand, Sections 14, 15, & 31

60 The Indian Law Commission considered this matter periodically. *14th Report On Reform of Judicial Administration*, 1958, Vol.1, Chapter 11; *77th Report On Delay and Arrears in Trial Courts*, 1978, *79th Report on Delays and Arrears in High Courts and Other Appellate Courts*, 1979

61 *Report of the Ceylon Banking Commission*, Sessional Paper XXII, Government Press, Colombo, 1934, Chapter IX; *Report of the Wimalaratne Committee On the Law and Practice of Debt Recovery*, Ministry of Justice, 1985



Recovery of Debts Due To Banks and Financial Institutions Act provides for the establishment of special debt recovery tribunals with powers to adjudicate debt recovery cases in a summary way. According to the latest information available, in 1995, only five out of ten tribunals the government planned to set up were established. They are in Ahmedabad, Delhi, Bangalore, Jaipur, and Calcutta.<sup>62</sup> In the tribunals in Ahmedabad and Jaipur, the presiding officers have been appointed, but they have not been provided with staff members, or initial facilities to commence work. In the remaining three tribunals, public interest litigation has almost stalled the smooth functioning of the tribunals. In Delhi, the Act was successfully challenged by the Delhi High Court Bar Council before the High Court. At present, the matter is before the Supreme Court. Special leave to appeal from the Order of the Delhi High Court has been granted by the Supreme Court. Meanwhile the order of the High Court has been stayed.<sup>63</sup> Consequently the Delhi Debt Recovery Tribunal is now functioning. In Calcutta, the High Court has issued numerous interim stay orders against the banks and the tribunal is functioning without adjudicating these cases.<sup>64</sup>

A number of problems relating to the jurisdiction of the tribunals have also been reported. The Bangalore tribunal has jurisdiction over the state of Andhra Pradesh but in a public interest litigation case the High Court of Andhra Pradesh has issued an interim order to the effect that debt recovery suits involving Rs.10 lakhs or more that have not already been transferred to the Bangalore tribunal should be continued in the civil courts. Similar orders have been issued by the High Courts of Punjab and Haryana preventing the transfer of cases to the Jaipur tribunal.

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62 Narayanan, R., and Shah, V., *Debt Recovery Tribunals* (1995) 66 Journal of The Indian Institute of Bankers 140, 141-144

63 (1995) 3 SCALE 53

64 Ibid.

The anticipated results from the establishment of debt recovery tribunals have not been achieved. High Court judges appear to have set themselves against cases being adjudicated by special tribunals. The legal profession is also vary of the tribunals.

Sudhir Shah an attorney from Bombay states,

“.....members of the legal profession must ensure that the dignity of judicial institutions are not diluted. If public confidence is eroded by formation of such tribunals in the guise of speedy remedies, the foundation of the system of justice delivery will weaken. Courts are constitutional institutions unlike Tribunals, which are statutory at most. The nature of work that the courts do must not be diluted and must not in any case be less important than that transferred to Tribunals.”<sup>65</sup>

The government of India must make a conscious effort to implement the provisions of the Debt Recovery Act. It is equally important that the Indian courts take into account the overall objective of the Act when petitions are filed. Unless the courts support the tribunals, the probability of achieving speedy debt recovery will be extremely low.

In Sri Lanka, the Debt Recovery (Special Provisions) Act was enacted to provide lenders with a speedy debt recovery procedure. Despite this legislation, bankers still prefer to file debt recovery suits in the civil courts under the Civil Procedure Code. Since the new debt recovery laws were enacted in 1990, banks and financial institutions have filed fewer than 400 cases. The Peoples' Bank, the largest state bank in the country, has filed the majority of these cases, and very few cases have been filed by the private banks.<sup>66</sup> A number of reasons contribute to the under-utilisation of this Act. Section 13 of the Debt Recovery (Special Provisions) Act states that it is the duty of a fiscal to execute a writ of execution in the same manner prescribed in the Civil Procedure Code. Section 218 sets out the circumstances in which a writ of seizure may not be executed, and dishonest borrowers appear to be making use of these to avoid

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<sup>65</sup> Shah, S., *Banking Regulation : Debt Recovery Tribunal* [1996] 3 JIBL N51, 52

<sup>66</sup> Interview with Mr. P. Gunasekera, Chief Legal Officer of the People's Bank, Peoples Bank Head Office, Colombo, on 14 May 1997.

seizure. For example, defendants often rent the mortgaged property to third parties as soon as an order absolute is made. Banks are then required to obtain an order from the court to eject the tenants before the writ of execution can be enforced. The lack of knowledge among judges and their lack of co-operation in debt recovery suits also deter banks from using the debt recovery laws. Apparently, some lawyers practising outside the larger cities are not even aware of the new legislation.<sup>67</sup> The debt recovery laws provide lenders with an effective mechanism to recover debts, but their implementation has proved to be extremely difficult. There are no easy solutions to these problems, particularly the practical difficulties encountered by bank and fiscal officers when seizing property. The more difficult but effective remedy in the long term is to instil in borrowers the belief that credit is not a right, and that default would inevitably result in adverse consequences. Borrowers must be informed that, in the event of default, future access to credit would be suspended. Adverse publicity, through publishing names of defaulters or those taken to court, and the sharing of such information with prospective lenders and other business organisations, could also be used as a warning against default.

In Malaysia, lenders file debt recovery actions in the Subordinate and High Court, depending on the value of the claim. Summary procedure is effectively used, and lenders do not consider debt recovery through the courts difficult. There appears to be no significant flaw in the law, although its administration could be more effective. Although the court procedure could be completed within a reasonable time, the execution of judgements may be delayed, due to the lack of bailiffs or resistance by borrowers.<sup>68</sup>

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67 Ibid.

68 Interview with Mr. Ismail, Senior Partner, Mohamed Ismail & Co, Kuala Lumpur, on 30 May 1997.

Bankruptcies and winding up of companies are not popular in India and Sri Lanka. If a debtor is unable to pay its debts, threatening insolvency as a pressure tactic is not considered an acceptable method of recovering debt. There is a distinct cultural and judicial preference for the rehabilitation of debtors. In India, petitions to wind up companies on the ground of inability to pay debts are not favoured by judges. In *Re. Navjivan Trading Finance Ltd.*, the Court held that winding up is a last resort, and cannot be insisted upon merely because the company is unable to pay its debts, if it appears that the company could be rescued.<sup>69</sup> Winding up of debtor companies is hardly reported in Sri Lanka. The records at the Registrar of Companies show that in the recent past not a single company had been wound up by court.<sup>70</sup> Due to the lack of use of this procedure, court officials are not familiar with the compulsory winding up process and official liquidators, if appointed, are indifferent to the time restrictions imposed by law. For example, the Companies Act states that, if a liquidation were not completed, an official liquidator must file half-yearly accounts with the court, as well as with the Registrar of Companies. These statutory provisions are usually ignored. The judges, court officials and staff at the Registrar of Companies are not knowledgeable about such requirements. Consequently, these omissions are undetected.<sup>71</sup>

In Malaysia, the position is very different. Winding up of debtor companies is frequently seen because there are no cultural values that restrict the use of insolvency laws. Lenders consider the threat of insolvency a very effective method to recover overdue debts. They also find the winding up procedure easier to deal with, because unlike court trials the entire procedure is administered by filing of papers and handled

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69 (1978) 48 Company Cases (Guj) 402

70 Interview with Mr. Hettiarachchi. D., Deputy Registrar, Registrar of Companies, Colombo, on 13 May 1997.

71 Ibid.

by lawyers. In practice, banks would not file winding up petitions, in order to safeguard their reputation and to avert the prejudice of other customers. Banks normally encourage an unsecured creditor to file the petition.<sup>72</sup> Malaysian insolvency laws are primarily pro creditor. In the 1980's, there were repeated calls for the introduction of a rescue procedure similar to the United States Chapter 11 procedure but this was resisted by the lenders.<sup>73</sup> Bankers are, however, becoming increasingly aware of their responsibility towards borrowers in financial difficulties, and are acting as unofficial business advisers, particularly, to small and medium scale industries. Bankers are also seeking professional help on how to re-organise companies in financial difficulties.<sup>74</sup>

### 6.3 CONCLUSIONS

The problems of debt recovery may be said to threaten the rule of law in India and Sri Lanka. The legal systems have become inefficient and the resolution of disputes takes many years, sometimes over two decades. Respect for the law and legal institutions is, as a result, on the wane. So far, the legal response to poor debt recovery has not achieved positive results. The reforms that were introduced were primarily focused on the symptoms of debt default rather than its causes. Most of the reforms were concerned with expediting debt recovery in the existing courts or through special tribunals. Given the high level of inefficiency in the judicial systems and the bureaucracy of government administration, the chances of these reforms being successful were limited.

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72 Interview with Mr. Ng Chih Kaye, May Bank Head Quarters, Kuala Lumpur, on 30 May 1997

73 Kamarul, B., *Chapter on Malaysia*, in Tomasic, R., and Little, P., *Insolvency Law and Practice in Asia*, FT Law & Tax Asia Pacific, Hong Kong, 1997, 172

74 Interview with Mr. Lim San Peen, Executive Director, Price Waterhouse, Kuala Lumpur, on 29 May 1997

This thesis has focussed on the broader context of debt recovery. Debt default could be reduced if lenders pay equal attention to the various stages of a lending transaction. Credit appraisal must be improved and the use of collateral security minimised. If there were an element of risk, and security were required, lenders should be willing to take a more varied range of securities, and to exercise their rights of extra-judicial enforcement when provided for by law. Loan agreements need to be carefully drafted and documentation for security prepared, preferably by lawyers. Loan supervision must be increased considerably, particularly where repayment schedules are not taken seriously by borrowers. The obligations of borrowers must be established before a loan is granted.

When a loan goes bad, it is too late to look at the causes of default, and lenders are then faced with the task of recovering the loan and the interest. Amending the existing legislation on its own would not be adequate to provide a lasting solution to the debt recovery crises. Institutional development is equally important, so that the existing laws are more effective in practice. Changes to improve the administration of the courts and fiscal offices, government registries for land and motor vehicles and the registrar of companies are essential. Banks, particularly the state banks, must improve their management and administrative procedures, because mistakes in credit allocation and debt recovery can be attributable to these deficiencies within banks.<sup>75</sup>

Whilst law reform and the strengthening of judicial administration and enforcement institutions are essential, it is equally important to provide training for bankers, judges and lawyers. Bank staff must have proper training in loan administration and dealing with the problems of borrowers. If the innovative credit

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<sup>75</sup> De Juan, A., *From Good Bankers to Bad Bankers : Ineffective Supervision and Management Deterioration As Major Elements in Banking Crises* (Unpublished) Washington DC, 1987

disbursement programmes based on the concept of “bare foot banking” are to be successful, bank officers must take a leading role. It is therefore important for bank staff to be aware of the new credit culture that is being promoted in their respective countries. Judges must be more committed to expediting the judicial process by striking out spurious defences and ordering trials to be conducted without unnecessary delays. Lawyers must also be conscious of their responsibilities to their clients and avoid acting in their self-interest. In short higher ethical standards should be expected from lawyers. As General Counsel of the European Bank For Reconstruction and Development observed:

“[t]here is little point in having well drafted laws...unless such laws are properly enforced by trained lawyers and judiciary....”<sup>76</sup>

The core of the debt recovery problem in India and Sri Lanka is external political influence that undermines the quality of credit decisions and the ability to supervise and collect loans when they are due. In Malaysia, the burden of political debts nearly triggered the collapse of several banks in the mid 1980's, but the governments intervened and averted it. The situation has since been improved. It is crucial that the laws and the judicial systems are improved to a high standard, so that they are considered a serious threat by defaulters. However, unless strong measures are taken to reduce political influence in credit allocation and debt recovery, the other reforms can only be partially effective.

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<sup>76</sup> Taylor, J., *New Laws, New Lawyers and the EBRD* (1996) 24 International Business Lawyer 98, 99

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## INTERVIEWS

1. Dr. Uthum Herath, Senior Economist, Central Bank of Sri Lanka Head Quarters, Colombo, on 4 June 1997
2. Mr. A. Cooray, Attorney at Law, on 28 June 1997 at Colombo, Sri Lanka,
3. Mr. D. Hettiarachchi, Deputy Registrar of Companies, at the office of the Registrar of Companies, Colombo, on 13 May 1997
4. Mr. Gopal Sundram, Head of the Legal Department, Bank Negara Malaysia, Kuala Lumpur, on 30 May 1997
5. Mr. Ismail, Senior Partner, Mohamed Ismail & Co, Kuala Lumpur, on 30 May 1997
6. Mr. L. Abeysekera, Chairman Sri Lanka Legal Aid Commission, formerly High Court Judge, on 30 October 1998 (by telephone).
7. Mr. Lim San Peen, Executive Director, Price Waterhouse, Malaysia, Kuala Lumpur, on 29 May 1997
8. Mr. M. Fernando, Deputy General Manager Credit Department, Peoples' Bank Headquarters, Colombo, on 14 May 1997
9. Mr. Mahayuddin Ismail, Senior General Manager - Retail Operations, Bank Islam, at Bank Islam Headquarters, Kuala Lumpur, on 30 May 1997
10. Mr. Morawaka, Retired Registrar of Companies, at 200 Darley Road, Colombo, on 8 May 1997
11. Mr. Ng Chih Kaye, Head Credit Division, May Bank Head Quarters, Kuala Lumpur, on 30 May 1997
12. Mr. P. Gunasekera, Chief Legal Officer, Peoples' Bank, at the Bank Head Quarters, Colombo, on 14 May 1997
13. Mrs Chan Yim Fun, Executive Director, PriceWaterhouse-Malaysia, Kuala Lumpur, on 29 May 1997
14. Mrs. Badariah Sahamid, Banking Law Lecturer, University of Malaya, Kuala Lumpur, on 2 June 1997

The interviews were conducted with the above persons with their consent and understanding that the information gathered would be used in this thesis. The author holds the original notes taken at these interviews.