

Development of Banking Law in Sri Lanka: A Critical Assessment

Banks and Banking Development

Despite the establishment of the Ceylon Savings Bank, the State Mortgage Bank and the Bank of Ceylon, nothing meaningful happened in the area of banks and banking law in the country until independence and the establishment of the Central Bank of Ceylon. Also, banking in pre-independence Ceylon was dominated by foreign banks (mainly British) and some Indian Banks.

The South Indian Natukottai Chettiar "merchant bankers" and the native "shroffs" of the foreign banks, acted as the middlemen between the Ceylonese borrowers and the lender banks. For an excellent discussion of banking and finance of that period, any researcher or student should look at the Pockhanawala Commission of 1934 as the country's first Banking Commission that was named after its Indian Chairman, Sir Sorabji Pockkanawala.

The Finance Minister of the first post-independence government of Ceylon (J.R. Jayawardena) deliberately looked not to England, our colonial master – but to the United States for assistance to setup our banking system. The Americans gave as Mr. John Exter who had just completed an overhaul of banking for the Philippines. John Exter transplanted his legislation for Philippines on Ceylon. His report (now a Sessional Paper) is an excellent one. By the Monetary Law Act of 1948, he set up a Monetary Board (the legal entity) and a Central Bank (popularly called Reserve Bank in Western

Countries and even in India). J.R. Jayawardena was said to have been very pleased with John Exter and invited him to be the first Governor of the Central Bank of Ceylon which post he accepted.

As a relevant anecdote, the name "Central Bank" posed no problem in the English language, but in Sinhalese and Tamil, it meant "*Madyama Bankuwa*" like a translation of "Central Province". The well-known Professor G.P. Malalasekera is said to have solved this dilemma. He had said to use the term "*Maha Bankuwa*" and no one will contest it. Also, the *legal entity* is the Monetary Board and not the Central Bank. In other words, any legal action by or against the Central Bank has to be in the name of the "Monetary Board".

Another post-independence milestone was the establishment by statute of the People's Bank in 1961 to take over and improve on the Co-operative Federal Bank which had been set up in 1949, but which had not been a success. Thereafter, (in my view) until about the mid 1977, when a new government espousing an open and liberalised economy was elected, nothing significant occurred in the manner we have now come to accept what banks can do to galvanise the economy. Until July 1977, except for the few developments mentioned above, as a whole, the country had a highly-regulated banking and financial system with strong Central Bank control.

Development of Banks and Banking Law after July 1977

After the election of a new government in July 1977, with the

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advice and assistance of the International Monetary Fund (IMF) and the World Bank (WB), significant developments took place in banking and the law associated with it. The most important was the enactment of the Banking Act. The Banking Act No 3 of 1988 (amended since then) supplemented the post-independence statute (Monetary Law Act No 58 of 1949) which established the Central Bank of Ceylon. It is these two statutes plus their amendments that banks should bind together and always have with them along with the several Gazette Notifications and Circulars issued by the Central Bank of Sri Lanka. The Banking Act defines "banking business" for Sri Lanka and provides the procedures for licensing of banks and their regulation and control by the Central Bank of Sri Lanka. Only incorporated bodies approved (licensed) by the Central Bank of Sri Lanka can engage in banking business.

Special Debt Recovery Laws for Banks

I now turn to what is considered as an extraordinary and special privilege that bankers in Sri Lanka enjoy. This type of privilege enjoyed by our banks is not found even in developed countries. We are here referring to the statutes (legislation) entitled:

- (i) Recovery of Loans by Banks (Special Provisions) Act No 4 of 1990 as amended.

(ii) Debt Recovery (Special Provisions) Act No 2 of 1990 as amended by Debt Recovery (Special Provisions) Amendment Act No 9 of 1994.

These two statutes which are categorised as special debt recovery legislation were the product of a report issued in 1983 by a Debt Recovery Committee, chaired by Mr. D Wimalaratne, a retired Supreme Court Judge. The legislation was not enacted until 1990, because of very strong opposition from the Sri Lankan Bar Association which argued that the proposed legislation was "discriminatory, draconian in their nature and harsh and superfluous". Yet despite all opposition, both statutes became law from 1990.

Recovery of Loans by Banks (Special Provisions) Act No 4 of 1990

Currently, this Act provides one of the most important statutory remedies (popularly called "*Parate Execution*") available to banks against defaulting borrowers. Whenever default is made in the payment of any sum due on a loan, the Board of Directors of any commercial or other specified bank may by resolution in writing authorise any person to sell by auction any property mortgaged to the said bank or may authorise any person to enter upon any immovable property mortgaged to the bank and to take possession of such property and thereafter, to manage and maintain such property until all monies due to the bank have been fully paid.

The majority of the reported case law on banks and banking since 1990 up to date is on "*Parate Execution*" cases. The country's newspapers have also benefited because, everyday, *Parate Resolutions of Banks* are advertised (as required) in the media.

Debt Recovery (Special Provisions) Act No 2 of 1990 as Amended by Debt Recovery (Special Provisions) (Amendment) Act No 9 of 1994

This is the second statute which gives extraordinary power to banks. This statute applies to all 'lending institutions' as defined in Section 30 of the Act. The term includes all licensed commercial banks and finance companies and specialised financial institutions. The statute provides a very easy summary procedure for the recovery of overdue debts. The term 'debt' is also given a wide definition in Section 21 of the Act (as amended).

While under Section 22 of the Act no money specified as a *penalty* for default or delay in payment of a debt can be recovered by a lending institution under these special procedures, the Roman-Dutch Law rule prohibiting the recovery of interest in excess of the principal sum lent has been abolished by this legislation. Even the Civil Law Ordinance of 1852 prohibited the recovery of interest in excess of the principal sum lent, but section 18 of the Amended Act No 2 of 1990 permits the recovery of interest in excess of the principal sum lent.

Issuing Cheques without Funds to Honour them

Although titled the Debt Recovery (Special Provisions) Act No 2 of 1990, the above-mentioned statute (quite strangely) also legislates on matters not connected with debt recovery. For instance, Section 25 of the Act makes it an offence for a person:

- (i) To draw cheques knowing that there are not sufficient funds in his bank account to honour such cheques;
- (ii) To draw cheques and then countermand their payment so that the cheques will not be honoured.

Many law enforcement officers and even some lawyers are not aware of the above new provisions (may be because it is found in this statute) and still proceed to prosecute such offenders under the "cheating" provisions of our Penal Code.

Supreme Court Narrows Down "Parate Execution" by Banks

In 2005, in a Five-Judge Supreme Court decision headed by the then Chief Justice Sarath Silva (with one dissent of Justice Shirani Bandaranayake) the Court refused to recognise that any property mortgaged other than by the borrower will be subject to *parate execution*. In other words, third party mortgages would be excluded from the right to *parate execution*. This judgment was delivered in the case of *Chelliah Ramachandran v Hatton National Bank*, Supreme Court Appeal Nos 5 and 9/2004 - S.C. Spl. Leave No. 32 & 33, decided on 1 April 2005). Accordingly, the signal sent by the Supreme Court is very clear. The judiciary will not extend *parate execution*. Rather, the judicial trend will be to narrow its operation. More recently, in 2011, Parliament passed amending legislation under which "*Parate Execution*" will not be permitted in the case of loans under Rs 5 million.

Nominations in Bank Accounts

Another little known development in banking law is the provisions enabling "*Nominations*" to any bank account other than current accounts. This was done by an amendment in 1993 to Section 544 of our Civil Procedure Code. Now, any customer can nominate any person of his choice to be the *beneficiary* of the assets of that account (e.g. Savings account or fixed deposit) and such nomination takes precedence even over a Last Will of that customer. Public awareness must be created about this "*nomination*" because banks as a matter of routine get customers to sign such

nominations without advising them of their effect. A customer may nominate a person known to him for convenience, but never intending that the nominee should benefit over his natural heirs.

Confidentiality of Bank Accounts

In England and many other countries, bankers' confidentiality and secrecy about bank accounts is an established principle of English common law. However, in Sri Lanka, these secrecy provisions have been embodied in section 77 of our Banking Act of 1988. My view is that we should have let the common law handle this topic because when you legislate lawyers often want to *interpret the legislation* to suit the case in hand!

Bank's Duty on Dormant Accounts

On the other hand, a good legislative provision is the provision in the Banking Act of 1988 relating to Dormant Accounts and abandoned property of customers. These are accounts not operated for over ten years. From 2008, the Central Bank of Sri Lanka has, *for the first time*, activated these statutory requirements, and now, all banks must report to the Central Bank of Sri Lanka any such assets (balances). The public would have seen newspaper advertisements of banks on this topic. In other countries, this is done every year, because, the statute applies to accounts that are not operated for ten years; so every year, the ten-year rule will apply to a few accounts. Up to 2008, one wonders what happened to monies in such dormant accounts.

No Significant Litigation and Judicial Decisions on Banking

A book published by the author, *Casebook on the Law of Banking and Cheques in Sri Lanka*, clearly shows that we do not have any major issues in this area. From the time of the Civil Law Ordinance of 1852,

it was the English law that clearly applies to banks and banking issues in the Island. Some doubts about the application of Roman-Dutch Law to banking was cleared by a Bench of Five Judges of our Supreme Court in the famous case of *De Costa v Bank of Ceylon* decided in 1969. In that case, the Bank of Ceylon was successfully sued for liability for *conversion* of a negotiable instrument as a Collecting Bank. There, five Judges of our Supreme Court gave several interesting judgments on how the English Law of Banking came to be applied in Sri Lanka. All the judgments run into a total of about seventy pages. In my view, the best judgment in that case was by Judge Christie Weeramantry who has now become a globally-recognised jurist of great eminence. By reading and understanding the judgments delivered in that case, one will get a good idea of banking law and its application in Sri Lanka.

Roman-Dutch Law is, however, our Common Law. Although it now applies only in two out of over 190 countries in the world (South Africa and Sri Lanka), any activity outside the "business of banking" (for example, guarantees and safe custody) will be governed by Roman-Dutch Law. However, in practice after the decision in *De Costa v Bank of Ceylon*, there has been no conflict for bankers between English and Roman-Dutch Law. Both laws have existed "in harmony" and the diversity of our country's legal system has not caused concern to bankers.

"Customary Banking Practices"

As stated earlier, English law applies to "banks" and "banking business". Section 86 of our Banking Act of 1988 in defining "banking business" speaks of customary banking practices. In June 2008, as a guide to our judiciary, the Association of Professional Bankers of Sri Lanka (APB) published in a booklet thirty four areas of activity engaged in by banks which are regarded as "customary banking practices" and

which should, therefore, be governed by English Law. At the APB's request, this writer compiled this publication which was launched by Senior Supreme Court Judge Mr. Justice Saleem Marsoof at a public event in Colombo. This compilation of "customary banking practices" in 2008 was a landmark event because no other country has done so.

Salgado Presidential Commission on Finance and Banking (1991)

It is appropriate to mention the work done by the Salgado Commission (named after its Chairman Dr. M.R.P Salgado) appointed by the then President in 1991. It issued nine reports on many important areas of banking and all these reports were published as Sessional Papers and contain invaluable information and data on the subject.

Whom does Banking Law Favour, Bankers or their Customers?

The answer to this question is not easy. Many bankers and average customers will say that banking law favours banks and that the scale is always tilted in favour of banks. However, if one does a careful evaluation of banking law and read through an established English text on banking law (such as *Paget or Chorley*), one will come to the conclusion that banking law favours customers rather than their banks. The following reasons are highlighted for the above view:

Firstly, banks have to comply with several statutory provisions in legislation such as the Banking Act, the Monetary Law Act, and other more recent legislation. The customers need not worry, because it is the obligation of banks to ensure that the legislative requirements are observed. As a famous English judge said, "The business of banking is not the business of the customer but that of the bank".

Second, banks act at their peril and take obvious risks in undertaking the payment and collection of cheques for their customers. No doubt, they make a profit by dealing in cheques, but when one closely examines the judicial decisions relating to payment and collection of cheques, it is clearly evident that banks have an onerous responsibility compared to their customers. A collecting bank's only protection from liability to an action for conversion is to prove that it acted in good faith and without negligence. Owing to the number of cheques that go through the banking system everyday, and because of the elaborate frauds practised by persons who steal other people's cheques, sometimes banks fail to prove that they were not negligent. Similarly, a paying banker's obligation is also onerous though he is not exposed to as many risk as a collecting bank. Forgery of signatures of cheques is also common risk. A bank that pays a forged cheque is liable to its customer. A forged mandate is no mandate.

On the other hand, compared to the onerous, day-to-day responsibility of banks, customers of banks, owe only *two* duties to their banks. First, to draw cheques carefully so as not to facilitate forgery. This is called the *Macmillan* duty after the English case that established it: see *London Joint Stock Bank Ltd v Macmillan* [1918] AC 777. The second duty is to inform the bank immediately of any forgery of his or her cheques, if such forgery has occurred. This is called the *Greenwood* duty based on the English decision in the case of *Greenwood v Martins Bank* [1933] AC 51.

Thus, it is evident that the law has placed a higher legal burden and

responsibility on banks than on their customers. It is only when customers borrow or take loans from banks that the roles are reversed. The customer – originally the depositor – creditor, now becomes the borrower – debtor and in lending transactions the law favours the banks such as by giving them special *parate execution* powers.

What I have said the above does not mean that it is easy to litigate against a bank. My advice is against it. The costs and delays in litigation will exhaust and frustrate any individual customer.

Recent Legislation of Importance to Banks and other Financial Institutions

Today in 2011, Sri Lanka has a vibrant Banking sector with local banks and branches of well-known foreign banks operating side by side. However, still the State banks (the Bank of Ceylon, the People's Bank and the National Savings Bank) dominate the banking sector with nearly 70% of the business. As regards Banking Law, we have in place today all the necessary statute law. I refer in particular to the following pieces of legislation which every banker should be conversant with:

- i. The Monetary Law (Amendment) Act No. 32 of 2002,
- ii. Information and Communication Technology Act No. 27 of 2003,
- iii. The Banking (Amendment) Act No. 2 of 2005,
- iv. Financial Transactions Reporting Act No. 6 of 2006,
- v. Prevention of Money Laundering Act No. 5 of 2006,

- vi. Convention on the Suppression of Terrorist Financing Act No. 25 of 2005,
- vii. Payment and Settlement Systems Act No. 28 of 2005,
- viii. Electronic Transactions Act No. 19 of 2006,
- ix. Computer Crimes Act No. 24 of 2007,
- x. Companies Act No. 7 of 2007,
- xi. Intellectual Property Act No. 36 of 2003,
- xii. Consumer Affairs Authority Act No. 9 of 2003,
- xiii. Payment Devices Frauds Act No. 30 of 2006,

Of the above legislations, the Financial Transactions Reporting Act of 2006 is of great day-to-day importance to banks. It laid down verification requirements for identification of customers, and under it, cash deposits of over Rs one million have to be notified to the Financial Intelligence Unit (FIU) now set-up in the Central Bank Sri Lanka. Under the Payment and Settlement Systems Act of 2005, cheque clearance is fully automated and now handled by Lanka Clear Ltd. and what we now get is a computer-generated facsimile of the cheque. The Electronic Transactions Act of 2006 and the Computer Crimes Act of 2007 takes care of the developments of E-Commerce.

I conclude this brief synopsis of the major *banking law* developments since independence in 1948 with comments about our Banking Regulator and the newly-established Financial Ombudsman Scheme.

The Central Bank's Role as the 'Regulator'.

As a Regulator the Central Bank of Sri Lanka has been "Pro-Active" when required to be so and acted as a Supervisor - which, in my view, should be its normal role. Today in 2011, we do not want "Regulators". What we want are "Facilitators". The Central Bank's duty is to safeguard the monetary system and the payment system. In the open economy which we now have in Sri Lanka too much regulation will impede development.

As a Regulator, Central Bank of Sri Lanka has done well. We have not had any major banking collapses. The Pramuka Bank collapse in 2002 was the last of recent origin. Despite, the "Golden Key" fiasco, the Central Bank of Sri Lanka stepped in and prevented any run on Seylan Bank. This Bank is now once again on a sound footing and doing well. True, a number of non-supervised financial enterprises failed - *Sakvithi, Danduwan* and then Golden Key - but to lay the blame for all these failures on the Central Bank of Sri Lanka is not fair. These were risky financial enterprises paying interest far above the normal possible rates. Also, Golden Key was not an institution supervised by the Central Bank of Sri Lanka which periodically by public notices informs the general public of Institutions supervised by them. When the Central Bank of Sri Lanka publishes notices naming the financial institutions supervised by them, they are indirectly saying all other financial institutions in question are not supervised and hence may be risky. This is the clear message.

Also one cannot take legal action against the Central Bank of Sri Lanka for loss of deposits in unsupervised institutions. In England also, the Courts have rejected legal claims against the Bank of England which is the Regulator in that country. Similarly, our Supreme Court has held that our Central Bank of Sri Lanka (Monetary Board) cannot be sued for loss of deposits in failed, unsupervised financial institutions.

Financial Ombudsman Scheme

My last comment is about the Financial Ombudsman Scheme which was commenced in 2003 which, in my view, has been a tremendous success. When you appreciate that it is a free service to customers, the success is more meaningful. I am also happy and proud to record that I was responsible (together with Mr. Gaston Gunawardene, the then Secretary General of the Bankers Association of Sri Lanka) for setting up the scheme. I recommended it to the Central Bank of Sri Lanka in 2002 when I was working as a Consultant there. After some hesitation, the banking industry agreed. It was then to be called the "Banking Ombudsman", but since other supervised financial institutions like finance companies, leasing companies and primary dealers also wanted to join, it was ultimately called the Financial Ombudsman's Scheme.

Every year, about three to four hundred customers come before the Financial Ombudsman for some relief. It is a very friendly service run at No.143A, Vajira Road,

Colombo 5. The procedure is not complex and inquiries are held without lawyers, and equitable decisions are given. The banks and other financial institutions who have joined the scheme support it and are anxious to ensure that it continues as a success.

It is from the success of the Financial Ombudsman Scheme that the Insurance Ombudsman Scheme was also commenced in February 2005, and I have been the Insurance Ombudsman from that date up to now. We both operate from the same building at 143A, Vajira Road, Colombo 5.

Now, we also have a Tax Ombudsman established by the Ministry of Finance. I am advocating that the government should encourage the setting up of more Ombudsman Schemes such as for private hospitals (now there are nearly 200 of them in the Island) for Electricity and Water services, etc. Even the Press Complaint Commission set up by the Editors Guild is a type of Ombudsman Scheme. We must encourage any system of dispute settlement which are alternatives to litigation which is both expensive and has long delays.

Footnote:

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