CHAPTER III

INTERNATIONAL CONVENTIONS ON E-BANKING AND THE ROLE OF WTO

3.1 Introduction

“Too much of this century was marked by force and coercion. Our dream must be a world managed by persuasion, the rule of law, the settlement of differences peacefully within the law and cooperation. It’s a good thing that all our living standards are now based on the ability of our neighbours to purchase our products. That’s where the WTO can do splendid work and advance the progress of the human species”.

Mike Moore¹

The World Trade Organisation² (herein after referred as WTO) began life on 1st January 1995, but its trading system is more than a half a century older. Since 1948, the General Agreement on Trade and Tariff (herein referred as GATT) had provided the rules for the system. The WTO is a place where member governments go, to try to sort out the trade problems they face with each other. WTO is not just about liberalizing trade, and in some circumstances its rules support maintaining trade barriers.³

The WTO was born out of negotiations; everything the WTO does is the result of negotiations. It is ‘rule based’⁴ and its rules are negotiated agreements. WTO is the only international body dealing with the rules of trade between nations. These documents provide the legal ground rules for international commerce. They are essentially in the nature of contracts binding governments

² Came into force on 1st January 1995.
³ For example to protect consumers, prevent the spread of disease or protect the environment.
⁴ At its heart are the WTO agreements, negotiated and signed by the bulk of the world’s trading nations. These documents provide the legal ground rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits.
to keep their trade policies within agreed limits. Although negotiated and
signed by governments, the goal is to help producers of goods and services,
exporters and importers in conducting their business prudently. Once a
government has made a commitment to open trade in service to foreign
competition, it must not normally restrict money being transferred out of the
country as payment for services and goods supplied in that sector.\(^5\)

Trade in goods was old one and rules were firmly established. The
establishment of the rule of law in services was the necessary step of the last
part of the 20\(^{th}\) century.

Cutting edge products, services and technologies allow offering customers
the highest quality products in the world at competitive prices when the playing
field is even and fair competition is permitted.

For this the first step is to assure that regulations are market oriented and
economically sound and that the regulatory agency has the capacity in terms of
resources and skills to implement solvency and prudential based regulation.\(^6\)

WTO council is the WTO’s highest-level decision-making body in Geneva,
meeting regularly to carry out the functions of the WTO. It has representatives
(usually ambassadors or equivalent) from all member governments and has the
authority to act on behalf of the ministerial conference which only meets about
every two years. Council for trade in services oversees operation of the
agreement.

\(^6\) Charles D. Lake, ‘Comments Regarding the General Agreement on Trade in Services’, Heinonline,
Negotiations on commitments in four topics have taken place after the Uruguay Round. General Agreement on Trade in Services (herein referred as GATS), has 29 articles covering all service sectors. They contain the general obligations which are Most Favoured Nations\(^7\) (MFN) treatment and transparency\(^8\) that all members have to comply.

GATS in terms of coverage is the most far reaching among the international legal instruments that regulate the terms of trade in services among nations.

The need for a trade agreement in services was long questioned, since the inception of GATT. Large segments have traditionally been considered as domestic activities that do not lend themselves to the application of trade policy concepts and instruments.

GATS changed the mode of thinking and services have recently become the most dynamic segment of international trade.

It is the first multilateral trade agreement that identified a few possible reasons like increasing economic importance of service production and trade as a result of technical progress, increased reliance on market forces in general.

The role of services, in particular with infrastructural relevant areas like finance, communication, banking, insurance and transport, positive impact of multilateral access guarantees on inflows of investment, skills and expertise and possibility to reap economies of scale and scope within an internationally

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\(^7\)Under Article II of the GATS, Members are held to extend immediately and unconditionally to services or services suppliers of all other Members “treatment no less favourable than that accorded to like services and services suppliers of any other country”. This amounts to a prohibition, in principle, of preferential arrangements among groups of Members in individual sectors or of reciprocity provisions which confine access benefits to trading partners granting similar treatment.

\(^8\)GATS Members are required, \textit{inter alia}, to publish all measures of general application and establish national enquiry points mandated to respond to other Member's information requests.
open services environment\textsuperscript{9} have been ensured. Few basic rules like MFN treatment, Transparency and Domestic Regulation constitutes the main GATS provision. However, their applicability is conditional upon the commitments filed by member countries. For example, the article on domestic regulation is applicable only to sectors where specific commitments have been taken\textsuperscript{10}.

The four important aspects that characterize the commitment process are

(i) the countries are free to decide which service sectors they wish to subject to market access and national treatment disciplines (later it was termed as positive approach to liberalisation),

(ii) countries can specify in their schedules, the limitations and exceptions they wish to maintain on market access and national treatment,

(iii) the market access and national treatment commitments are made for each of the four modes of supply and

(iv) the GATS commitment structure is voluntary and flexible by nature.\textsuperscript{11}

A country is free to provide for restriction in the schedule of commitments for any particular type of services as provided in Article XVI\textsuperscript{12} on market access.

\textsuperscript{10}Under Article IV:4 of the GATS.
\textsuperscript{12}This Article deals with market access, which states through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.
The multilateral frameworks of GATS are-

(a) limits discrimination as the MFN treatment allows the most efficient suppliers to gain market share
(b) allow concessions in one area to be traded against liberalisation in other areas in partner markets
(c) offers a neutral forum for dispute settlement and enforcement
(d) guarantees market access by binding liberalisation and
(e) provides for a systematic process to negotiate further liberalisation.\(^\text{13}\)

The definition of services trade under GATS is four pronged.

This depends on the territorial presence of the supplier and the consumer, the place where the agreement takes place, the law prevailing in that country and what is in the agreement, at the time of the transaction. And there are four modes of trading in financial service pursuant to the GATS which are utilized by the traders or suppliers of the service in the international market\(^\text{14}\) which are as follows-

(a) from the territory of one member into the territory of any other member (Mode 1-Cross Border Trade),
(b) in the territory of one member to the service consumer of any other member (Mode 2-Consumption Abroad),
(c) by a service consumer of any other member (Mode 3-Commercial presence) and

(d) by a service supplier of one member, through the presence of natural persons of a member in the territory of any other member (Mode 4-Presence of Natural Persons).

Almost 80% of limitations in market access have been taken in banking and other financial services. Over 60% of all measures were concentrated in Mode 3.\textsuperscript{15} Significantly developing countries like India, wanted that the developed countries commit on Mode 1 and 4 in the Doha conference which received positive response.\textsuperscript{16}

The most preferred of all the modes, is mode 4 especially for the developing countries. This is because the developing countries have a clear interest in ensuring that significant liberalization takes place in the movement of natural persons in the provision of services. This interest is not only in respect to the movement of professionals, but also, and arguably more importantly, in respect of semi-skilled and unskilled persons. This is due to the fact that the greater comparative advantage of the developing over the developed countries is in the abundance of semi-skilled and unskilled persons, as opposed to skilled professionals.\textsuperscript{17}

The concept of financial integration denotes the economic integration of financial markets and activities which meant elimination of legal obstacles obstructing cross border flows of capital, financial services and financial institutions and the economic and technical forces that facilitate cross border

\textsuperscript{17}Enos A. Brown, ‘\textit{Movement of Natural persons (Mode 4) under GATS’}, Paper presented to the WTO Symposium on the Movement of Natural Persons, Geneva, Switzerland on April 11 to 12, 2002.
financial activities, so that with respect to finance there are no foreigners within the integrated area.18

Objectives of GATS are, first the establishment of a multilateral framework of principles and rules in the form of GATS aimed at progressively opening up trade in services contributing to economic development worldwide, second, WTO members, particularly developing countries would still have to regulate the supply of services to meet national policy objectives, and third, it should be a key objective of the international trade regime to help developing countries take a fuller part in world trade in services, particularly through strengthening the capacity, efficiency and competitiveness of their own domestic services.19

3.2. Trade in Banking Services and Multilateral Negotiations in WTO-
1986 International Conventions and its After Effects

The WTO is an organization made up of 15920 member countries with about some more countries applying to join21. Its main function is to ensure that trade between nation’s flows as smoothly, predictably and freely as possible. It functions like a club which national governments apply to join. If accepted as members, they are committed to abide by the rules and settle disputes in an agreed way. Like most clubs, membership provides rewards and requires obligations. In case of WTO, the rewards to each member are the economic benefits from liberalized trade; the obligations involve some mutually agreed upon codes of behaviour that are deemed acceptable in return for the benefits.

19See GATS Preamble.
20This figure as on March, 2013.
21For example Afghanistan, Algeria, Andorra, Azerbaijan, Bahamas, Belarus, Libya, Montenegro, Sudan, Syrian Arab Republic who have been observers and are yet to join.
The benefits are it helps to promote peace, disputes are handled constructively, freer trade cuts the costs of products and qualities, trade raises incomes, trade stimulates economic growth, government are shielded from lobbying and system encourages good government.

3.2.1. Uruguay Round of Trade Negotiations

The GATS, the most significant product of the Uruguay Round or trade negotiations is in terms of coverage, is a far reaching international legal instruments that regulates the terms of trade in services among nations. The 1997 Financial Services Agreement\(^{22}\) and the specific national commitments on financial services operate against the legal and institutional framework established by the GATS.

The GATS itself, in the preamble to the official text, makes reference to the three underlying ideas i.e MFN treatment, transparency and market access, that shaped the negotiation and formulation of the final text. At the end of the Uruguay Round in 1993, negotiations on financial services remained largely unfinished.\(^{23}\)

The unfinished were telecommunications and maritime transport. Some specific commitment\(^{24}\) to provide market access and national treatment were made in the sector, but most developed countries with an interest in open financial markets did not consider them sufficient to conclude the negotiations.

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\(^{22}\)On December 13, 1997 this agreement came into force. US and other WTO countries reached an agreement on a financial services package that will help open global markets in financial services. Under the agreement, the U.S. committed to maintain its open market in financial services, and other countries also followed to open their markets to foreign firms.


\(^{24}\)Where there are were no commitments on MFN exemption which would result in less favourable treatment to be given.
Hence, it was decided to insert MFN treatment principle. With this, second round of negotiation began and ended on 28th July, 1995 and entered into force on September, 1996.\(^{25}\)

### 3.2.2. Financial Services Negotiations, 1997

The new round of financial services negotiations was launched in April, 1997. Members again had an opportunity to improve, modify or withdraw their commitments in financial services and take MFN exemptions in the sector. As a result of the negotiations a new and improved set of commitments in financial services under the GATS was agreed on 12th December, 1997.

The commitments included that foreign investors should have same access to domestic market and treated same as domestic industry, the right to establish an industry and operate competitively, removal of restriction on cross border services, reduction of barriers, and exception to commitment should be precise and transparent and no new restriction should be created.\(^{26}\)

A total of 56 schedules of commitments representing 70 WTO member governments and 16 lists of MFN exemptions were annexed to the fifth protocol to the GATS, which was open for ratification and acceptance by members until 1999.\(^{27}\) India committed itself to this negotiation and based on this deleted an MFN exemption on reciprocity in insurance, banking and other financial services.

### 3.2.3. The Doha Round

The Doha Round is the latest round of trade negotiations among the WTO membership. Its aim is to achieve major reforms of the international trading system through the introduction of lower trade barriers and revised trade rules. The work program covers about twenty areas of trade.

The Round is also known semi-officially as the ‘Doha Development Agenda’\(^{28}\) as its fundamental objective was to improve the trading prospects of developing countries.

The Round was officially launched at the WTO’s Fourth Ministerial Conference in Doha, Qatar, in November 2001. The Doha Ministerial Declaration provided the mandate for negotiations, including on agriculture, services and intellectual property.

In Doha Round a decision was taken on the procedure to address the problems of developing countries like agriculture, obtaining patents, special and differential treatment and in implementing the WTO agreements.\(^{29}\) The negotiations on trade in services were conducted with a view to promoting the economic growth of all trading partners and the development of developing and least developed countries. The negotiation was relating to work already undertaken in the negotiations, initiated in January 2000 under Article XIX of the GATS\(^{30}\). Large number of proposals\(^{31}\) was submitted by members on a

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\(^{28}\)This agenda was drafted with an object of committing all countries to negotiations opening agricultural and manufacturing markets, as well as trade-in-services (GATS) negotiations and expanded intellectual property regulation (TRIPS). The intent of the round, according to its proponents, was to make trade rules fairer for developing countries.


\(^{30}\)Negotiation of Specific Commitments and Progressive Liberalisation was the theme of this Article.

\(^{31}\)Proposals such as special attention is to be given to export interests of developing countries, Negotiations will include discussions on eliminating existing exemptions from most-favoured nation treatment in order to ensure equal treatment among all WTO members, emergency safeguard and subsidies.
wide range of sectors and several horizontal issues, as well as on movement of natural persons.

The members accepted the guidelines and procedures for the negotiations adopted by the Council for Trade in Services on 28th March 2001 as the basis for continuing the negotiations with a view to achieving the objectives of GATS as stipulated in the Preamble, Article IV32 and Article XIX of that Agreement.33 The General Council was supposed to take note of the progress made by the members.

With a view to providing effective market access to all Members and in order to ensure a substantive outcome, members were supposed to strive to ensure a high quality of offers, particularly in sectors and modes of supply of export interest to developing countries, with special attention to be given to least developed countries.34 The Council emphasized that the members should also aim to achieve progressively higher levels of liberalisation with no priority exclusion of any service sector or mode of supply to developing countries.

The Council aimed at providing targeted technical assistance with a view to enabling developing countries to participate effectively in the negotiations. For this purpose, in the Sixth Ministerial meeting, the special session of the Council for Trade in Services reviewed the progress and provided full repost to the Trade Negotiation Committee including possible recommendations. The recommendations were implemented in the interest of the member countries.

32 Increasing Participation of Developing Countries.
3.2.4. Transparency Mechanism for Preferential Trade Arrangements, 2010

Transparency Mechanism for Preferential Trade Arrangements, 2010\(^{35}\) is the latest WTO agreement related to electronic transfer mechanism. The transparency mechanism agreement applies to the following Preferential Trade Arrangements (PTAs). PTAs falling under on Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries (Enabling Clause) with the exception of regional trade agreements\(^{36}\) as described in the General Council Decision, PTAs which take the form of preferential treatment accorded by any member products of least developed countries and other non reciprocal preferential treatment authorized under the WTO Agreement.

The purpose of this Mechanism is to enhance transparency of the PTA under consideration. These procedures do not prejudge the substance of the relevant provisions of the Enabling Clause or any other instrument as referred above nor affect Members’ rights and obligations under the WTO Agreements in any way. Notifying members shall specify under which provision their PTAs are notified.\(^{37}\) The notifying Member shall make available to the WTO Secretariat data as required under the Agreement. If the PTA covers several

\(^{35}\) Came into force on 4\(^{th}\) October 2010. It constitutes another pillar for implementing transparency in international trade relationships. It aims to increase members’ and the public’s understanding about the legal nature, history and background of each preferential trade arrangement (PTA), the range of products covered and the types of preferential treatment offered.

\(^{36}\) For greater clarity, since it has been notified to the GATT/WTO under paragraph 2(c) of the Enabling Clause, the Global System of Trade Preferences (GSTP) is not covered by the mechanism, but instead, is covered by the General Council Decision arrived on 14\(^{th}\) December, 2006 (Transparency Mechanism for Regional Trade Agreements).

\(^{37}\) The Member notifying a PTA shall provide the full text of the related legislation and any related instruments like regulations, annexes, schedules, protocols, in one of the WTO official languages and in an electronically exploitable format, including, when appropriate, internet links.
sub-schemes the data should be detailed enough so as to allow an analysis by sub-scheme. Disaggregated data, if available for these sub-schemes shall also be provided by the Member in an ‘Electronically Exploitable Format’.38

3.2.5. Geneva Ministerial Conference

Trade ministers at the 8th WTO Ministerial Conference39 held at Geneva adopted a waiver to enable developing and developed country members to provide preferential treatment to services and service suppliers of least developed country (LDC) members.40 The Conference concentrated on service sectors and specifically service provided by LDC’s. The emergence of the internet has created a range of internationally tradable products variant from e-banking to tele health and distance learning that were unknown decades ago and has removed distance related barriers to trade that had disadvantaged suppliers and the users in remote location. The Conference dealt with matters relating to trade in professional services such as software development, consultancy and advisory matters also.

3.3. WTO and Financial Services

Financial services under GATS include all insurance and insurance related services and all banking and other financial services41. The notion of banking services includes the following activities, accepting of deposits and other repayable funds from the public, lending of all types, financial leasing, all

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38‘Electronically Exploitable Format’ means that entire data sets of a Member’s annual data can be downloaded without undue restrictions i.e no limitations on the number of tariff lines or records that could be downloaded, and in the formats that lend themselves to processing into data base format by the WTO Secretariat.
39Adopted on 17th December, 2011.
41Article I of the GATS.
payment and money transmission services including credit, and debit cards, travelers cheques and bankers draft, guarantees and commitments, provisions and transfer of financial information and financial data processing and related software by suppliers of other financial services, advisory, intermediation. It also includes other auxiliary financial services on all the activities listed in this list including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.42

The annex covers all types of financial services provided by the banks. The international trade in banking services, the institutional framework and national commitments established under the GATS in general and the 1997 Financial Service Agreement in particular, largely define the current state of affairs concerning banking sector. To understand the methodology and normative impact of this framework, there are no less than seven legal instruments to consider43 which are (a) the GATS, which is a general framework agreement governing the liberalisation of the entire services economy, including banking and financial services (b) the GATS Annex on Article II exemptions that determines the circumstances under which nations may depart from the overarching MFN principles (c) the GATS Annex of Financial Services that contains important provisions regarding trade in financial services and often exempts financial services from the general provisions of GATS (d) the

42 See GATS, Annex on Financial Services.
Understanding on Commitments in Financial Services entered into financially developed countries to undertake the liberalisation commitments that in many important respects exceed the degree of liberalisation achieved under the general 1997 Financial Services Agreement (e) the Schedules of specific commitments and lists of Article II exemptions that contain the specific commitments undertaken by individual countries in different sectors, modes of supply, and specific types of service (f) the second protocol to the GATS, also known as the Interim Agreement and (g) the fifth protocol to GATS the so-called Financial Services Agreement that incorporates the commitments currently in force in the field of banking and financial service.

Generally, the 1997 Financial Services Agreement and the specific national commitments on trade in banking services operate against the legal and institutional framework established by GATS. The framework consists of a central set of rules, the core text of the GATS, a number of ancillary legal texts, which are either annexed to the Agreement or informally, agreed upon by the national representatives. GATS cover all measures taken by the members affecting trade in services and all service sectors. Certain GATS obligations are of general application in all sectors of the services economy, while others depend on the sector specific commitments assumed by individual members. This is the major structural weaknesses of GATS regime for financial services.\(^4\) The discrimination that certain obligations are mandatory and others are optional has weakened the GATS.

3.3.1. India and WTO on Financial Service

The 1997 Financial Services Agreement\textsuperscript{45} was a key moment in the history of International financial integration. Within the context of a legally binding international agreement, a substantial number (2/3\textsuperscript{rd}) of WTO members have committed themselves to eliminate or reduce discriminatory barriers to trade in banking and financial services. India too has committed itself to the Agreements and from the point of developing jurisdictions it has been a boon where the developed countries being able to go much further in their liberalisation commitments.

It is true that the WTO mostly benefit the developed countries. But it does not mean developing countries have gained nothing.\textsuperscript{46} According to Mr. A.V.Ganesan\textsuperscript{47}, says ‘---that Final Act involves a radical departure from our present policies, laws or regulations. In all our Final Act such as agriculture, foreign investment, services, intellectual property right, obligations and commitments envisaged under the various agreements are not at conflict with our current policies or the direction in which our policies are moving under the economic liberalisation’.

India is a founder member of both GATT and the WTO as it has signed both on the date its draft was ready.\textsuperscript{48} In the new millennium, Indian enterprises

\textsuperscript{45}This agreement was reached on 19\textsuperscript{th} December, 1997.
\textsuperscript{46}The policies of the WTO impact all aspects of society and the planet, but it is not a democratic, transparent institution, the domination of international trade by rich countries for the benefit of their individual interests fuels anger and resentment that make developing countries less safe, would privatize essential public services such as education, health care, energy and water, etc. which is not beneficial to developing nations.
\textsuperscript{47}Elected member of Dispute Settlement Body of the WTO and India’s Chief negotiator in the Uruguay Round.
\textsuperscript{48}India Signed WTO and GATS on 1\textsuperscript{st} January, 1995.
have introduced modifications in technologies imported from the developed countries which can be an advantage to financial sectors development. Globalization throws many challenges for financial sector; like competition, deregulations and the most critical element is its survival in the face of changing technology; there is a quantum leap in the needs and demands of people for new products and services. Finance sector reforms generally are followed by trade reforms. India is taking a bold step by activating the currency markets through introduction of liberalisation by way of privatization and participation foreign corporates. The success is dictated by the technological advancements in their operations. With powerful computers and satellite technology, services may be transported across the globe, instantaneously. And India is striving itself to achieve all these.

3.4. International Conventions on E-Banking

The diffusion of personal computers to large segments of the population, the creation of innovative software and the availability of dial-up modems connected to a global telephone network were technological breakthroughs that all came together in the late 1980’s and early 1990’s to create the basic infrastructure for the emerging digital economy. Everything from photography to entertainment to communication to bank accounts to financial information can be digitized and therefore can be shaped, stored processed and transmitted. This can be done through computers, the internet, satellites or fiber-optic cable, at a high speed, with total convenience.

In their basic form financial transactions involve the creation, transfer and settlement of claims which being intangible in nature, do not rely on paper to circulate. The power of the internet to create an integrated global market for financial services and financial flows is substantially large compared to traditional financial service.

The global process of economic integration comes close to the popular notion of economic globalization. Globalization can be defined as the free movement of goods, services, labour and capital, thereby creating a single market in inputs and outputs; and full national treatment for foreign investors and nationals working abroad, so that economically speaking, there are no foreigners.\footnote{Martin Worlf, ‘Why Globalization Works’, New Haven, Yale University Press, (2004), p.14.} The political process of globalization through the reduction of legal barriers is the essential precondition for setting in motion the economic process of globalization.\footnote{Brick Lindsay, ‘Against the Dead Hand: The Uncertain Struggle for Global Capitalism’, New York, Wiley, (2002), p.275.}

E-commerce refers to all forms of commercial transactions that involve individuals and organizations based on the electronic processing of data. The UNCITRAL Model Law on Electronic Commerce (MLEC)\footnote{It has formulated rules relating to formulating the legal notions of non-discrimination, technological neutrality and functional equivalence, and has established rules for the formation and validity of contracts concluded by electronic means, for the attribution of data messages, for the acknowledgement of receipt and for determining the time and place of dispatch and receipt of data messages.} proposed two principles of functional equivalency and technology neutrality that could possibly also be regarded as general principles of internet law.

From the early stages of development of electronic commerce it became apparent that online activities would be subject to established notions of legal
and regulatory control. In sharp contrast with the romantic view of internet modernists, which used various metaphors to describe cyberspace as an unregulated area beyond the reach of national governments, online communications, speech and economic transactions were duly brought within the scope of national regulations. In practice, national regulators and services have affected local markets in a broad range of legal contexts, including standards of advertising and financial promotion, banking regulation, consumer protection and conduct of investment business.

Electronic commerce is about doing business electronically. It is based on the processing and transmission of data including text, sound and video. It encompasses many diverse activities including electronic trading of goods and services, online delivery of digital content, electronic fund transfers, electronic share trading, electronic bill of lading, commercial auctions, online sourcing, public procurement, and direct consumer marketing and after sales services.

Electronic banking can be defined as the provision of banking services and the initiation and performance of payments through the banking system by electronic means and other advanced technologies. Electronic banking has been around and accepted by customer in the form of Automated Teller Machines (ATM’s) and telephonic transaction; however, internet banking has

transformed electronic banking and serves as a remote delivery channel. Internet has introduced significant changes in commercial interaction.

Internet banking is primarily regarded as a business priority and a strategic necessity by most financial institutions. Internet banking removes traditional geographical barriers and reaches out to customers in different countries. Internet banking is a system enabling customer to access accounts and general information on banks products and services through their personal computers by connecting to the banks website. Internet banking as a global phenomenon is the driving force, which has shaped the banking industry.

Maturation of internet has brought about changes to the method of payment. It allows customers to access banking 24 hours and empowers them to choose when and where they conduct their banking while saving money and time. Internet banking is advantageous because there is no intermediary in its framework, the transaction on the account is directly taken to the bank.

From the economic perspective, information technology and computer networks have enhanced the automation, speed and standardization in communications and internal administration, increasing customer convenience and functionality and reducing costs in back office and front desk banking functions.58

It appears that education, age and profession are the most influential demographic variables, alongside income and customer acceptance of efficient and speed service which have developed the e-banking as is now.

58 Allen Berger, *loc. cit.*
To meet many problems, associated with enable and facilitate commerce conducted using electronic means by providing national legislators with a set of internationally acceptable rules aimed at removing legal obstacles and increasing legal predictability for electronic commerce in general. And in particular, to overcome obstacles arising from statutory provisions that may not be varied contractually by providing equal treatment to paper-based and electronic information, thus fostering efficiency in international trade, the United Nations (UN) adopted through the United nations Commission on International Trade Law (UNCITRAL), Model Law on e-commerce in the year 1996. This was to harmonize the e-commerce.

Challenges are identified and recommendations are made on how to improve the regulatory framework and create an environment conducive to investment and economic development.59

The Model Law on Electronic Commerce (MLEC), 1996, purports to enable and facilitate commerce conducted using electronic means by providing national legislators with a set of internationally acceptable rules aimed at removing legal obstacles and increasing legal predictability for electronic commerce. In particular, it is intended to overcome obstacles arising from statutory provisions that may not be varied contractually by providing equal treatment to paper-based and electronic information. Such equal treatment is essential for enabling the use of paperless communication, thus fostering efficiency in international trade.60

59 Z. N. Jobodwana, loc. cit.
60 See UNCITRAL Model on Electronic Commerce.
The MLEC was the first legislative text to adopt the fundamental principles of non-discrimination, technological neutrality and functional equivalence that are widely regarded as the founding elements of modern electronic commerce law.

3.4.1. UNCITRAL and E-Banking (Electronic Fund Transfer)

The banking laws, regulations and supervision were designed primarily to address the fundamental principle relating to safe and sound business practices by financial institutions. In order to maintain safe and sound business practice it is of at most important that customers are protected against losses resulting from inadequate remedies available to them. Banking by its very nature is a high risk business. However, the major risks associated with banking are legal risks, credit interest rates and liquidity. Internet banking has increased some these risks by creating new ones. Electronic fund transfers are based on technology which by its nature is designed to extent the geographical reach of banks and customers. This kind of a market expansion extend beyond borders, therefore are problems which banks will try to avoid through regulation and supervision. Other regulatory and legal risks include, the uncertainty about legal requirements in some countries and jurisdiction ambiguities regarding the responsibilities of different national authorities. Computers first entered the backrooms of banks as a means of handling more efficiently the increasing

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62 Financial institutions should comply with all legal requirements relating to e-banking, including the responsibility to provide their e-banking customers with appropriate disclosures and to protect customer data.
63 Customers and banks may be exposed to legal risks associated with non-compliance with different national laws and regulations including consumer protection laws, record keeping and report requirements.
volume of paper based funds transfers. The introduction of magnetic ink character recognition (MICR)\textsuperscript{64} and optical character recognition (OCR)\textsuperscript{65}, on both debit and credit transfer instructions permitted the automated processing of standardized paper documents. This development increased the efficiency with which clearing houses and individual banks were able to cope with the increased number of funds transfers and often caused a wholesale reorganization of the clerical operations of the banks. The creation of computer centers by banks led some of them to centralize the record-keeping of customer accounts at the computer centre rather than to continue the previous decentralized record-keeping of accounts by each branch.\textsuperscript{66}

3.4.2. UNCITRAL Model Law on International Credit Transfers

UNCITRAL Model Law on International Credit Transfers\textsuperscript{67} applies to credit transfers\textsuperscript{68} where any sending bank and its receiving bank are in different States and to other entities that as an ordinary part of their business engage in

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\textsuperscript{64}By the mid-1950s, the Stanford Research Institute and General Electric Computer Laboratory had developed the first automated system to process cheques using MICR. MICR is a character-recognition technology used mainly by the banking industry to ease the processing and clearance of cheques and other documents. The MICR encoding, called the MICR line, is placed at the bottom of cheques and other vouchers and typically includes the document-type indicator, bank code, bank account number, cheque number, cheque amount, and a control indicator. The technology allows MICR readers to scan and read the information directly into a data-collection device.

\textsuperscript{65}OCR, is the mechanical or electronic conversion of scanned images of handwritten, typewritten or printed text into machine-encoded text. It is widely used as a form of data entry from some sort of original paper data source, whether documents, sales receipts, mail, or any number of printed records. It is a common method of digitizing printed texts so that they can be electronically searched, stored more compactly, displayed on-line, and used in machine processes such as machine translation, text-to-speech and text mining.

\textsuperscript{66}See UNCITRAL Legal Guide on Electronic Funds Transfers.

\textsuperscript{67}Adopted on 15\textsuperscript{th} May, 1992.

\textsuperscript{68}‘Credit Transfer’ is defined under section 2(a) UNCITRAL Model Law on International Credit Transfers. means the series of operations, beginning with the originator’s payment order, made for the purpose of placing funds at the disposal of a beneficiary. The term includes any payment order issued by the originator’s bank or any intermediary bank intended to carry out the originator’s payment order. A payment order issued for the purpose of effecting payment for such an order is considered to be part of a different credit transfer.
executing payment orders in the same manner as it applies to banks. The Commission suggests the following text for States that might wish to adopt it.

The rights and obligations arising out of a payment order shall be governed by the law chosen by the parties. In the absence of agreement, the law of the State of the receiving bank shall apply shall not affect the determination of which law governs the question whether the actual sender of the payment order had the authority to bind the purported sender.

For the purposes it stated that where a State comprises several territorial units having different rules of law, each territorial unit shall be considered to be a separate State and branches and separate offices of a bank in different States are separate banks.

There are many obligations defined under article 5 of the law which are as follows-

(1) a sender is bound by a payment order or an amendment or revocation of a payment order if it was issued by the sender or by another person who had the authority to bind the sender,

(2) when a payment order or an amendment or revocation of a payment order is subject to authentication other than by means of a mere comparison of signature, a purported sender who is not bound is nevertheless bound if the authentication is in the circumstances a commercially reasonable method of

69 ‘Payment Order’ means an unconditional instruction, in any form, by a sender to a receiving bank to place at the disposal of a beneficiary a fixed or determinable amount of money if the receiving bank is to be reimbursed by debiting an account of, or otherwise receiving payment from, the sender, and the instruction does not provide that payment is to be made at the request of the beneficiary. Nothing in this paragraph prevents an instruction from being a payment order merely because it directs the beneficiary’s bank to hold, until the beneficiary requests payment, funds for a beneficiary that does not maintain an account with it.
security against unauthorized payment orders and the receiving bank has
complied with the authentication,

(3) the parties are not permitted to agree that a purported sender is bound if the
authentication is not commercially reasonable in the circumstances,

(4) a purported sender is, however, not bound if it proves that the payment
order as received by the receiving bank resulted from the actions of a person
other than a present or former employee of the purported sender, or a person
whose relationship with the purported sender enabled that person to gain access
to the authentication procedure\(^{70}\),

(5) a sender who is bound by a payment order is bound by the terms of the
order as received by the receiving bank\(^{71}\), and

(6) a sender becomes obligated to pay the receiving bank for the payment order
when the receiving bank accepts it, but payment is not due until the beginning
of the execution period.

Apart from the above, the model also deals matters relating to, who is
paying and receiving banker, acceptance or rejection of a payment order by
receiving bank other than the beneficiary’s bank, circumstances affecting
acceptance of rejection of a payment order by beneficiary’s bank, obligations
of a beneficiary bank, time for receiving bank to execute payment order and
other miscellaneous matters.

\(^{70}\) This does not apply if the receiving bank proves that the payment order resulted from the actions of a
person who had gained access to the authentication procedure through the fault of the purported sender.

\(^{71}\) However, the sender is not bound by an erroneous duplicate of, or an error or discrepancy in, a
payment order if the sender and the receiving bank have agreed upon a procedure for detecting
erroneous duplicates, errors or discrepancies in a payment order, and use of the procedure by the
receiving bank revealed or would have revealed the erroneous duplicate, error or discrepancy.
The law also imposes penalties in case of non-compliance with the rules of the law. This law does not deal with issues related to the protection of consumers. The law has only focused on banker side who are involved in electronic transfer of funds and protection to these bankers.

3.4.3. UNCITRAL Model Law on Electronic Signatures

The United Nations Commission on International Trade was mindful that the Model Law on Electronic Signature\(^{72}\) would be a more effective tool for States modernizing their legislation on electronic signature. The present Guide to Enactment has been prepared by the Secretariat pursuant to the request of UNCITRAL made at the close of its thirty-fourth session, in 2001.

It is based on the deliberations and decisions of the Commission at that session\(^ {73}\) when the Model Law was adopted, as well as on considerations of the Working Group on Electronic Commerce, which conducted the preparatory work.

The increased use of electronic authentication techniques as substitutes for handwritten signatures and other traditional authentication procedures has suggested the need for a specific legal framework to reduce uncertainty as to the legal effect that may result from the use of such modern techniques, which is called ‘Electronic Signature. ‘Electronic Signature’ means under article 2(a) of the model, is a data in electronic form in, affixed to or logically associated with, a data message, which may be used to identify the signatory in relation to

\(^72\)Resolution adopted by the General Assembly [on the report of the Sixth Committee (A/56/588)] adopted on 12\(^ {th}\) December, 2001.

the data message and to indicate the signatory’s approval of the information contained in the data message. ‘Data message’ means information generated, sent, received or stored by electronic, optical or similar means including, but not limited to, electronic data interchange, electronic mail, telegram, telex or telexy. ‘Signatory’ means a person that holds signature creation data and acts either on its own behalf or on behalf of the person it represents. In the same session when UNCITRAL model of Electronic Commerce was enacted, unification on law on electronic signature was also proposed as there was no uniformity in national law on the issue.  

The risk that diverging legislative approaches be taken in various countries with respect to electronic signature instigated for uniform legislation to establish the basic rules of what is inherently an international phenomenon. There are basically three types of risks in electronic signature, they are, insecurity as to identity of person, insecurity as to integrity of information and insecurity as to privacy of information.

Electronic Signature does not look like hand written signature and have nothing like writing down a name.

A signature evidences the signer will and has intention to be bound by the written document, the animus signandi.  

‘Electronic Signature’ is done by two methods, one by just clicking “I Agree’ and second one by using ‘pin’ and ‘password’. The law on electronic signature applies where the electronic  

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75 Means intent to sign an instrument.
signature are used in commercial activities. Its objective is to protect the consumers.

An electronic signature is considered to be reliable under Article 6 of the model, if the signature creation data are within the context in which they are used, linked to the signatory and to no other person, the signature creation data were at the time of signing under the control of the signatory and of no other person, any alteration to the electronic signature, made after the time of signing, is detectable and where the purpose of the legal requirement for a signature is to provide assurance as to the integrity of the information to which it relates, any alteration made to that information after the time of signing in detectable.

This model also deals with conduct of the signatory under article 8 which states, to notify any person that may reasonably be expected by the signatory to rely on or to provide service in support of electronic signature, if the signatory knows that the signature data have been compromised or the circumstances that is known to the signatory that the signature data have been compromised, and the signatories has to take reasonable care in case of material alteration in the signature. And in case the signatory does not comply with these rules he shall bear the consequences. The conduct of the certification service provider is also note worthy in this convention. The service provider shall exercise reasonable care to ensure the accuracy and completeness of all material representations made by it that is relevant to the certificate. It has to provide reasonable accessible means which shall enable a relying party to ascertain from the
certificate such as, the identity of the certification service provider, that the signatory that is identified in the certificate had control of the signature creation data at the time when the certificate was issued and that signature creation data were valid at or before the time when the certificate was issued.76

Article 10 of the convention states the procedure to determine trustworthiness of the service provider. A relying party shall bear the legal consequences of its failure if it has not taken reasonable steps to verify the reliability of an electronic signature; or where an electronic signature is supported by a certificate, to verify the validity of the signature.77 An electronic signature created or used outside shall have the same legal effect in as an electronic signature created or used in, if it offers a substantially equivalent level of reliability. This depends upon the State which is adopting the model. The model can be adopted after signing it.

3.4.4. United Nations Convention on the Use of Electronic Communications in International Contracts, 2005

The UN Convention on Use of Electronic Communications in International contracts, 200578 applies to all electronic communications exchanged between parties whose place of business are in different States when at least one party has its place of business in a Contracting State.79 It may also apply by virtue of the parties' choice. Contracts concluded for personal, family or household purposes, such as those relating to family law and the law of succession, as

76 Article 9 of the UNCITRAL Model on Electronic Signature, 1992.
77 Article 11 Ibid.
78 Adopted on 25th November, 2005 by its resolution 60/21.
79 Article 1 of the UN Convention on the Use of Electronic Communications in International Contracts, 2005.
well as certain financial transactions, negotiable instruments, and documents of title, are excluded from the Convention's scope of application.\textsuperscript{80}

The Convention sets out criteria for establishing the functional equivalence between electronic communications and paper documents as well as between electronic authentication methods and handwritten signatures.\textsuperscript{81} Similarly, Article 10 the Convention defines the time and place of dispatch and receipt of electronic communications, tailoring the traditional rules for these legal concepts to suit the electronic context and innovating with respect to the provisions of the Model Law on Electronic Commerce.

Article 8 establishes the general principle that communications are not to be denied legal validity solely on the grounds that they were made in electronic form. Specifically, given the proliferation of automated message systems, the Convention allows for the enforceability of contracts entered into by such systems, including when no natural person reviewed the individual actions carried out by them.\textsuperscript{82} Article 11 states that a proposal to conclude a contract made through electronic means and not addressed to specific parties amounts to an invitation to deal, rather than an offer whose acceptance binds the offering party, in line with the corresponding provision of the CISG. Moreover, the Convention establishes remedies in case of input errors by natural persons entering information into automated message systems (Art. 14).

The Electronic Communications Convention (ECC) aims at facilitating the use of electronic communications in international trade by assuring that

\textsuperscript{80} Article 2 \textit{ibid.}
\textsuperscript{81} Article 9, \textit{Ibid.}
\textsuperscript{82} Article 12, \textit{Ibid.}
contracts concluded and other communications exchanged electronically are as valid and enforceable as their traditional paper based equivalents. The aim of the Convention is to remove legal obstacles like who are the contracting parties, electronic signature on the contract, validity of such contract, and such other matters related to electronic communications and contracts. The Convention regulates the use of electronic communications in electronic contracting between parties whose places of business are in different states. The Convention applies not only to data exchanged over the internet using web pages or e-mail, but also extends to older technologies such as Electronic Data Interchange (EDI) or even telefax, telex and telegram. The term contract is also given a wide meaning to include not only contracts of sale or services, but also arbitration agreements. Furthermore, pre and post contractual communications will also be covered such as electronic notices sent during the performance of the contract. The Convention applies to any transactions performed electronically provided that commercial parties are located in different states.\footnote{Paul Przemyslaw Polanski, ‘International Electronic Contracting in the Newest UN Convention’, vol. 2, \textit{Journal of International Commercial Law and Technology}, (2007), p.114.}

Similar to earlier developments in international commercial law such as electronic signature, the new Convention is limited to Business-to-Business (B2B) electronic commerce only. Consequently, its provisions do not create any rights or obligations for online entrepreneurs with respect to contracts concluded for personal, family or household purposes. Therefore, any contracts concluded between professional party and a consumer (B2C) or between
consumers themselves (C2C) or between consumers and business party (C2B) are excluded from the scope of the Convention. Hence, the Convention applies only when transaction takes place between banker and a banker who are residing in different States i.e. as a clearing agent.

3.5. European Convention

The main object of the European Union is to promote throughout the Community a harmonious, balanced and sustainable development of economic activities. The creation of a single European market\(^8^5\), of which the internal market is a fundamental component, is believed to be the most important way to achieve this ambitious goal. By the abolition of obstacles like tariff and duties, to the free movement of goods, persons, services and capital, the European Union wishes to make an integrated European market world’s most competitive and dynamic market.\(^8^6\)

The European Community Treaty (ECT)\(^8^7\) marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as openly as possible and as closely as possible to the citizen. The objectives of the treaties are stated under Article 2 which are-

- to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development, in particular through the creation of an area without internal frontiers,

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\(^8^5\)A single market is a type of trade bloc which is composed of a free trade area (for goods) with common policies on product regulation, and freedom of movement of the factors of production (capital and labour) and of enterprise and services.


through the strengthening of economic and social cohesion and through the establishment of economic and monetary union, ultimately including a single currency in accordance with the provisions of this Treaty.

- to assert its identity on the international scene, in particular through the implementation of a common foreign and security policy including the progressive framing of a common defence policy, which might lead to a common defence.
- to strengthen the protection of the rights and interests of the nationals of its Member States through the introduction of a citizenship of the Union.
- to maintain and develop the Union as an area of freedom, security and justice, in which the free movement of persons is assured in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime.
- to maintain in full the acquis communautaire and build on it with a view to considering to what extent the policies and forms of cooperation introduced by this Treaty may need to be revised with the aim of ensuring the effectiveness of the mechanisms and the institutions of the Community.

Article 12 of the Treaty is framed to pursue certain objectives like defining the principles of and general guidelines for the common foreign and security policy, deciding on common strategies, adopting joint actions, adopting

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88The term is French word, *acquis* means “that which has been agreed upon”, and *communautaire* means “of the community”.
common positions and strengthening systematic cooperation between Member States in the conduct of policy.

Part III, Title III of the Treaty deals with movement of services and persons. It states, within the framework of the provisions, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.\(^{89}\) The liberalisation of banking and insurance services connected with movements of capital shall be effected in step with the liberalisation of movement of capital.\(^{90}\)

The treaty is the individual liberty to engage in economic activities and the requirement that legal and institutional impediments to economic liberties, including restrictions on international trade, be justified on worthy grounds relating to the public interest at large. The internal market is the backbone of European integration which is founded upon laws and institutions established under the ECT and the remainder of primary community law. There is mutual recognition of national laws, freedom of service and the treaty itself.

The relation between e-commerce and trade in financial services is a primary objective of policy reforms pursuant to the Financial Services Action Plan. With regard to international trade in the context of the WTO, one key factor driving the interest in the services component of the international trade negotiations is the increasing number of services that can be traded electronically without having to establish a physical presence in the importing

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\(^{89}\)Article 49 of the ECT.
country. This is with a view to establish single European market in which free movement of financial services and capital is guaranteed.

The European law\textsuperscript{91} governing the contractual aspects of electronic banking activities is an amalgamation of the law of contracts, the law of banker-customer relationship and depending on the particular aspect of the service, the law governing distinct banking contracts and services, normally found in English common law and equity and in the rest of Europe, in civilian codifications, such as the civil and commercial codes of jurisdictions like France and Germany.\textsuperscript{92}

The European Community Law provides that there is requirement of separate ‘internet service’ contract establishing special rights and obligations with regard to the availability and use of online internet service. The conceptual link between the single European market in financial services and internet banking is the opportunity to use computer networks to provide banking services via the internet across national borders. There is a central clearing house which facilitates clearing operation.\textsuperscript{93}

There are of course legal barriers such as tariffs and duties, to international economic integration and this exists even in European Community. This can be express and intentional i.e direct or discriminatory barriers such as tariffs and duties or indirect and inadvertent i.e non-discriminatory or indirect barrier such as equality in law, equal conditions of competition, and multilayered

\textsuperscript{91}EP and Council Directives 2000/12/EC.
governance. With the advent of liberalisation of financial markets and national banking systems, direct barriers have become less frequent. But indirect barriers still exists due to divergent local laws.

The object of single European market was to reduce these barriers by bringing all the European countries under a single law. Hence, there were three prong set of institutional reforms.

A single banking licence recognized throughout the community on the basis of ‘home country’ control.

The institutional and legal framework for carrying on electronic banking activities in the single European market is affected by a range of policies and legal reforms which are conceived and pursued by different Directorates General of the European Commission, including measures relating to financial services, consumer protection and electronic commerce.

Regarding financial services, adoption of single currency, increasing awareness of the power of efficient financial markets to stimulate growth and prosperity and ongoing advances in information technology and network technology are also launched in European market. In the original Treaty of Rome, there was no reference to consumers and consumer interests and there was also no explicit competence conferred on the EC in the consumer field till

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95 They are minimum harmonization of national regulatory and supervisory standards, the mutual recognition by member States of one another’s rules and supervision, and the allocation of legislative, supervisory and enforcement jurisdiction in prudential matters to the authorities of the bank’s home state in relation to activities carried on at home and services provided in other member states.
96 Means which laws will apply to goods or services that cross the border of Member States.
97 Came to force of 25 March 1957, was framed to lay the foundations of an ever-closer union among the peoples of Europe and to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe.
the Treaty of Maastricht\textsuperscript{98} which projected with attainment of high level of consumer protection.\textsuperscript{99} Hence, now consumer protection is at most taken care of.

Policies in the field of electronic commerce were introduced in 1997 with the hope of encouraging electronic commerce in the single market which ultimately resulted in 2000 E-Commerce Directives\textsuperscript{100}. The communication on E-Commerce and Financial Services proposed three main policies, first, convergence in contractual and non-contractual rules, second, consumer confidence in cross border redress and internet payments, and third, cooperation among national authorities. The most common liberalisation policies and institutional reforms towards the integration of financial markets are de-regulatory, often, re-regulatory in character\textsuperscript{101} ultimately resulting in harmonization programmes.

A wide range of harmonization programmes were undertaken in second banking directives. Those included freedom of movement of capital, mutual recognition of the systems of operation by member states, home country supervision, freedom of establishment and provision of services, abolition of endowment capital requirement for branches, limits on holding in non-financial institution, etc. The European Court of Justice (ECJ) concerning the regulatory

\textsuperscript{98}The Treaty on European Union (TEU), signed in Maastricht on 7 February 1992, entered into force on 1 November 1993. The Treaty introduced the concept of European citizenship, reinforces the powers of the European Parliament and launches economic and monetary union.


\textsuperscript{101}They are de-regulatory as the reforms entail the elimination of legal and institutional barriers to trade in financial services and movements of capital. And, the process of financial integration is often re-regulatory if the undertaken legal commitments of financial liberalisation are complemented by or premised upon the harmonization of national laws.
interests has stated\textsuperscript{102} that the ‘host country’ may invoke to justify restriction on the free movement of services if formulated on the concept of ‘general good’. The ‘general good’ derogation is guaranteed by the economic freedom in the ECT which is recognized on the principle that free economic movement has to be based on mutual recognition of laws and regulatory stands and this can be restricted by measures taken by the ‘host country’ only when these measures can be justified by the imperative reasons relating to public interest. The public interest is taken into consideration only when it is adequately protected by the laws of the country of origin of the goods or services in question.

A bank operating in the single market under the freedom to provide services could be forced to bring their services in compliance with the legislation of the host country only if the pertinent measures are in the interest of the ‘general good’ and has met with all the conditions imposed by the ECJ\textsuperscript{103}. There are five strict conditions imposed by the ECJ which are, that they must be applied in a non-discriminatory manner to domestic and overseas financial institution, that they must be justified by imperative requirements in the general interest, that they must be suitable for securing the attainment of the objective which they pursue, that they must not go beyond what is necessary in order to attain those objectives and if less restrictive measures are adequate to protect the public interest, those measures shall be preferred and finally the pertinent of public interest must not be adequately protected by the rules to which the financial institution providing the services is subject in the country in which this person

\textsuperscript{102} Case C-76/90, Sager v. Dennemeyer & Co; Ltd, (1991), ECR I-4221, para 15.

is established. The ‘general good’ principle applies to the conduct of electronic banking activities also.\textsuperscript{104}

The conduct of cross border activities raises many questions such as international cooperation in the supervision of increasingly integrated financial markets, reliance of financial institutions on advanced information technology and computer networks, soundness and security of individual banks and broader repercussions for the financial system as a whole, etc. The solvency and soundness of financial institutions was first recognized by the court in \textit{Commission of European Communities v. Federal Republic of Germany}\textsuperscript{105}, where it stated that the policies are to be in the interest of consumers and would be a valid ground for restricting the free movement of services.

The specific question of bank safety and soundness was addressed in \textit{Parodi}\textsuperscript{106}, where the court accepted that in absence of sufficient legal convergence of prudential banking regulation, national measures restricting the freedom to provide banking services were justified because the banking sector was regarded as a particularly sensitive area from the point of view of consumer protection. This requires transparency and disclosure in the contract, honesty and integrity, consumer protection norms.

On the matter of risk, prudential regulatory concerns caused by electronic banking activities are more dealt in Basel Committee and the same is adopted by the European Community. The EU applied Basel II to all credit institutions

\textsuperscript{104}Electronic banking activity raises several different types of risks and regulatory concerns. Policy makers are primarily concerned with the systemic stability and soundness of banks and the adequate protection of ordinary consumers, depositors and investors.

\textsuperscript{105}Case C-205/84, (1986), ECR 3755, para 39.

\textsuperscript{106}Case C-222/95, \textit{Societe Civile Immobiliere Parodi v. Banque H Albert de Bary et Cie}, (1997), ECR I-3899.

3.6 Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision,\textsuperscript{107} (BCBS) provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques with a view to promoting common understanding. The committee uses its common understanding to develop guidelines and supervisory standards in the areas where they are considered desirable.

The committee is known for its international standards on capital adequacy; the core principles for effective banking supervision; and the concordat on cross border banking supervision. The committee work is organized under four main sub-committees which are standards implementation group, the policy development group, the accounting task force and the Basel consultative group.

3.6.1. Basel I

From 1965 to 1981 there were about eight bank failures (or bankruptcies) in the US. Bank failures were particularly prominent during the 1980’s, a time which is referred as the ‘savings and loan crises’. ‘Saving and loan crises’ was due to the volatile interest rate climate in 1970’s. A large numbers of depositors

\textsuperscript{107}The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries which are Belgium, Canada, France, Germany, Italy, Japan, Netherland, Sweden, Switzerland, United Kingdom and U.S.A in 1974. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland.
removed their funds from savings and loan institutions (S&Ls) and put them in money market funds, where they could get higher interest rates since money market funds weren't governed by Regulation Q, which capped the amount of interest S&Ls could pay to depositors. S&Ls, which were largely making their money from low-interest mortgages, did not have the means to offer higher interest rates, though they tried to once interest rate ceilings were dropped in the early '80s. As S&L regulations loosened, they engaged in increasingly risky activities, including commercial real estate lending and investments in junk bonds.

Banks throughout the world were lending extensively, while countries’ external indebtedness was growing at an unsustainable rate. As a result, the potential for the bankruptcy of the major international banks grew due to low security. In order to prevent this risk, the BCBS, comprising of central banks and supervisory authorities of ten countries, met in 1987 in Basel, Switzerland and first Basel Accord was enacted in 1988 which was named as Basel I.

The object was to draft best global practices and banking standards. They introduced a capital measurement system, commonly referred as Basel Capital Accord. Basel I Accord focused on the management of credit risk by introducing minimum capital requirement. The Accord was designed to provide a minimum standard of capital ratio to different banks in various jurisdictions. Though the Accord was drafted to satisfy the needs of G-10 nations, it was a benchmark for banks solvency, hence was adopted by other

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countries also. It introduced more efficiency on credit risk and market risk arrangements.\textsuperscript{109} The committee drafted its first document to set up an international ‘minimum’ amount of capital that a bank should hold. This ‘minimum’ is a percentage of the total capital of a bank is also called ‘minimum risk-based capital adequacy’.\textsuperscript{110}

There were numerous problems with Basel I. Capital regulation lies at the heart of supervision in line with the risk of potential losses arising from business transactions was understood later. The first obstacle was the alignment of the definition of capital itself, which was to be framed keeping in mind the different elements of the capital prevailing in the member countries.

The second was regarding return on capital, banks with poor capital requirements and substantially lower margins, could not lend compared to their restricted peers. Thirdly, as a result of discrepancies and unequal competition, banks with strict capital regulation norms would try to take more risk and high margin lending to cope-up with their business. Finally, the mixture of these pressures would make it more difficult for banks and supervisors to maintain prudential standards.\textsuperscript{111}

The measurement of capital identifies certain important purposes for which bank capital is required like to provide and cushion to absorb losses, to demonstrate to potential depositors, the willingness of the shareholders to put


\textsuperscript{110}The purpose of Basel I Capital Accord was to strengthen the stability of international banking system and set up a fair and a consistent international banking system in order to decrease competitive inequality among international banks.

their own funds at risk on a permanent basis, to provide resources free of fixed
financing and to be a stable form of finance for the general infrastructure of the
business.\textsuperscript{112} Furthermore, the Basel I Accord did not provide the division of
responsibility between the home country and the host country. Consolidated
supervision entrusted the home country to control the host country operations
but the total risk was based on the capital adequacy at the home country’s bank.

Cranston\textsuperscript{113} criticized capital adequacy standards as they were overly
complex, the standards could distort a bank’s activities, the standards were
insufficiently precise to measure accurately the risk a bank faced, the risk
weightings were crude and there were variations in the way the standards have
been adopted in different jurisdictions. Llewellyn’s\textsuperscript{114} analysed the Accord as
the risk weights applied to different assets and contingent liabilities, were not
based on precise measures of absolute and relative risk, the methodology of
summing the risk did not take into account the extent to which assets and risks
were efficiently diversified, no allowance was made for the risk mitigating
factors, major differences within a bank’s overall portfolio still existed, bank
changed regulatory capital requirements by lowering capital costs and by not
reducing the risk and there was no implementation of operational, legal or
reputation risk.

Nevertheless, the Basel I Accord (original draft 1988), created awareness
among the banking institutions that they should run business with a set of rules

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\textsuperscript{112}J.J.Norton, ‘Bank Regulation and Supervision in the 1990’s’, London, Lloyd’s of London Press,
\textsuperscript{113} Ross Cranston, \textit{op. cit.}, pp.89-91.
\textsuperscript{114}David Llewellyn, ‘A Regulatory Regime and the New Basel Capital Accord’, vol. 9, \textit{Journal of
\end{flushleft}
and procedures which are flexible and consistent. Basel I largely ignored both the heterogeneity of the asset class and its differential risk sensitivity.

This led to the emergence of the new Basel Accord-Basel II, squarely focusing on risk management through proper development of a unique internal rating framework for the assessment of capital adequacy. Basel II encompasses three types of risks inherent in the business i.e credit risk, market risk and operational risk (OpR) of which the most difficult one is the operational risk and hence controversial.

3.6.2. Basel II

Basel II is the second of the Basel Accords, (now extended and effectively superseded by Basel III), which is series of recommendations on banking laws and regulations issued by the BCBS. Basel II is different from Basel I. Basel II is a combination of capital adequacy and risks in banking sector and has a definite impact on market discipline, ensuring that banks have risk management strategy. After the draft was ready, Jean Claude Trichet, Chairman of the G-10 group of central bank governor and head of bank supervisory authorities and the President of the European Central Bank stated,

“Basel II embraces a comprehensive approach to risk management and bank supervision...It will enhance banks safety and soundness, strengthen the stability of the financial system as a whole and improve the financial sectors ability to serve as a source for sustainable growth for the broader economy”.

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115Ross Cranston, loc. cit.
Basel II, initially published in June 2004 was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks and the whole economy would face. One focus was to maintain sufficient consistency of regulations so that this does not become a source of competitive inequality amongst internationally active banks.\textsuperscript{119}

In theory, Basel II attempted to accomplish the object, by setting up risk and capital management requirements designed to ensure that a bank has adequate capital for the risk the bank exposes itself through its lending and investment practices.

These rules mean that the greater risk to which the bank is exposed to, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

The main aim of Basel II Accord is to reduce the probability of prudential failure in a cost efficient way, to create greater transparency in the setting of regulatory capital standards and to promote a strong culture of risk management.\textsuperscript{120} More important, however, are the wide range of business implications and risk management challenges that Basel II could trigger for banks, their non-bank competitors, customers, rating agencies, regulators and ultimately, the global capital market. Under this, banks were asked to implement an enterprise wide risk management framework that ties regulatory

\textsuperscript{119} Advocates of Basel II believed that such an international standard could help to protect the international financial system from the types of problems that might arise when a major bank or a series of banks collapse.

\textsuperscript{120} Eva Semertzaki, \textit{et. al., op. cit.}, p. 20.
capital to economic capital. Bank customers had to collect and disclose new information and had to face new risk structures as a result of increased transparency.

Rating agencies were given new prominence under the Accord and thus could experience new competition, regulators were asked to provide a level of playing field on the Basel Committee recommendations which were required to be implemented by legislatures in various countries. The global banks could experience extended trends towards securitization as financial institutions adapted to the new accord.

The new capital adequacy frame consists of ‘three pillars’. Pillar one is minimum capital requirements (addressing risk), pillar two is a supervisory review and the third pillar is effective use of market discipline. The overall aim of the proposed Basel II is to ensure that a bank’s capital is more closely calibrated to the risks it faces, rather than resting on the comparatively crude yardsticks in the current rules (pillar 1).

The Basel I accord dealt with only parts of each of these pillars. For example, with respect to the first Basel II pillar, only one risk, i.e. credit risk was dealt in a simple manner while market risk was afterthought, whereas operational risk was not dealt at all. Under pillar 1, the Basel Committee has laid down a standardized approach for minimum capital requirements.

The committee replaced the established approach or checking risk by the use of external credit assessment. This approach would reduce the risk of

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corporate credits. There are three benefits of minimum capital requirements which are internationalizing the social costs of bank failure, improvements in risk management and reduction in regulatory forbearance.\textsuperscript{122} Hence, this pillar covers the quantitative aspects of capital standards, creating more risk sensitive measurements of capital requirements.\textsuperscript{123}

The securitization framework determines the capital requirement for traditional and synthetic securitizations or similar structure that contain features common to both. Initially operational risk was not proposed as part of the capital accord. Later in 2004 it was included because this was the major risk faced by the banks. OpR includes legal risk which arises from violations of or non-conformance with laws, rules, regulations or prescribed practices or when the legal rights and obligations of parties to a transaction are not well established.\textsuperscript{124} Legal risk is high in areas such as internal controls, security, payment and clearing systems and in the matters relating to information management. Banks are advised to move along the spectrum towards the more sophisticated method.

The second pillar, which deals with supervisory review of capital adequacy, the Basel II helps individual banks to maintain their capital assessment through an internal capital assessment process. This internal capital assessment sets the exact capital with the risk taken by the bank.

\textsuperscript{123}The minimum capital requirement will use credit risk, operational risk and market risk for its measurement. Credit risk can be measured through a standardized approach, or by the internal rating based approach. The internal rating based approach is more advanced method of measuring capital and is created to be used by large and advanced banks.
The second pillar keeps a track that whether a bank’s capital position is consistent or not with the risk undertaken by the bank. To comply with the pillar II, banks must implement a consistent risk adjusted management framework that is comparable in its sophistication to and closely linked with the risk approaches the bank chose under the pillar 1.

The last pillar deals with market discipline which is an important component or modern financial regulation. Basel II includes methods for greater qualitative and quantitative information to raise awareness among and information for stakeholders.

This enables the market and investors to make qualified evaluations of the financial institutions. It acts as a counterweight to increased discretion accorded to banks in estimating their capital requirement. The benefit of the accord has been manifold. Basel II drives banker to become risk-return driven.\(^\text{125}\) It deals matters relating to improved risk management and date flows which enable banks to identify target clients, evaluate their customers in a more thorough way and determine whether to retain certain customers or not. Banks have to request new and timely information from borrowers to perform the internal rating assessments and collateral evaluation that are essential to Basel II risk calculation process. On its business impact, the New Accord encourages banks to assume a new role as information intermediaries, a role, in which they collect and analyze customer-related data using systematic risk appraisal and

\(^{125}\text{Once banks can attribute risk to a potential transaction, product or process, they can ascribe a portion of economic capital to it based on the risk it poses, define an expected return on it, consider how best to price it, consider the risk mitigating techniques and thereby decide whether to enter a transaction, engage in a business or pursue an activity or process.}\)
classification processes and tools. Customers who can supply such information may choose to bypass a bank and go straight to the capital markets to obtain capital.\footnote{http://www.scribd.com/doc/93024305/kpmg. Accessed on 25th July, 2012.}

For their part, banks armed with more information about potential customers could potentially compete with the capital markets in supplying capital. Indeed, Basel provides incentives for banks to transfer credit risks through instruments such as asset backed securities or credit derivatives, while retaining the customer relationship. The banking industry’s improved risk management, enhanced information flows and related disclosures could drive parallel improvements in the stability of the financial markets. New disclosures will provide regulators with warnings that bank or rating agencies could pass on the public and investors, potentially enhancing trust in the financial markets.

Basel II incorporates numerous provisions recognizing a certain degree of discretion to national authorities. A good baseline supervisory system is always equipped to alter the decisions concerning the implementation.

Impact on the timing of its application is the state of necessary infrastructure, including legal/regulatory infrastructure, human resources, disclosure regime, and corporate governance and accounting provisioning practices. Once the accord is adopted, it is necessary to ensure the improvement of those infrastructures while determining the scope of application.

Market discipline supplements regulation as sharing of information facilitates assessment of the bank by others including investors, analysts,
customers, other banks and rating agencies which leads to good corporate governance. The aim of pillar 3 is to allow market discipline to operate by requiring institutions to disclose details on the scope of application, capital, risk exposures, risk assessment processes and the capital adequacy of the institution. It must be consistent with the procedure adopted by the senior management including the board access and manage the risks of the institution.

3.6.3. Basel II and Indian Banks

Indian banking scenario is going through a transition. Indian banking system has made noteworthy strides, post the reforms it implemented after the adoption of the Basel I framework in 1992 and further up to meet the requirements of the Basel II framework. Given the spread and reach of the Indian banking system, with wide spread of branches of more than 100 banks, implementation is a challenge for the supervisors.

However, the RBI is committed to full implementation of the core principles. The bank also serves on the core principles of BCBS, which has been formed to promote the timely and complete implementation of these principles worldwide. Commercial banks in India have implemented Basel II. They have adopted Standardized Approach for credit risk and Basic Indicator Approach for operational risk. This required large capital mainly due to capital required for operational risk. The RBI has introduced capital instrument both in Tier I and Tier II available in other jurisdictions. In addition, RBI has involved in capacity building for ensuring the regulator’s ability for

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identifying and permitting eligible banks to adopt internal rating based/measurement approaches.129

A two stage implementation of the guidelines is envisaged to provide adequate lead time to the banking system. Accordingly, the foreign banks operating in India and the Indian banks having operational presence outside India are required to migrate to the Standardized Approach for credit risk and the Basic Indicator Approach for operational risk with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them, but, in any case, not later than March 31st, 2009.

It has been a conscious decision to begin with simpler approach available under the framework. As regards the market risk, the banks will continue to follow the Standardized Duration Method, already adopted under the Basel I framework, under Basel II also.130

Department of Banking Supervision (DBS) is responsible for the supervision of commercial banks and their merchant banking subsidiaries. Both regulation and supervision of the development financial institutions are handled by the Financial Institutions Division of the DBS. Banks in India were augmented to bear with the operational costs as the risk of operational cost would be higher due to liberalisation policy.

3.6.4. Failure of Basel II

Basel II Accord was drafted with certain objectives but could not achieve the same. First, capital requirement ratio as suggested could not be achieved, second, larger banks gained advantage over small banks due to requirement of heavy investment, hence failed to achieve competitive equality among banks, and finally, the accord cannot be seen so as to constitute a more comprehensive approach to addressing risks. Even the treatment of new risks that the Committee did address was considerably watered down during the regulatory process. Banks were eventually allowed to use their own models to determine capital charges for market risk. Basel II relied on banks own estimates.

BCBS secretariat in its working paper stated that it expected that the new accord would enhance the soundness of financial system by aligning regulatory capital requirements to the underlying risks in the banking business and also that it would encourage better risk management and enhance market discipline. But this was overlooked.

The banks have limited liability. They shift the risk to others and keep the reward. As a result most benefits of banks come from such risk. Hence what is required is there should be risk sensitivity means sensitivity to private risks is a wrong goal. Instead capital requirement should be related to social risk which the accord had not addressed.

The Basel II did not address the numerator of capital adequacy ratio, bank capital, but only the denominator of risk weighted assets. Basel II failure lies in regulatory capture, de facto control of the state and its regulatory agencies by

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the regulated interests, enabling these interests to transfer wealth to themselves at the expense of society.

Large international banks were able to systematically manipulate the outcome of Basel II regulatory process to their advantage, at the expense of their smaller and emerging market competitors and above all systemic financial stability.\textsuperscript{132} Basel II does not promote the interests of individual members of the Basel Committee, but rather those of large international banks regardless of their national origin. Hence, Basel III was drafted and is now the Accord.

3.7. Basel III

The global banking lobby has managed to block structural reform aimed at averting another financial crisis. It first stalled radical reform measures to restrict the activities of banks and break down institutions that were too big to fail. The focus then shifted to Basel III\textsuperscript{133} proposals that would strengthen capital requirements.\textsuperscript{134} Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the BCBS in 2010-11.\textsuperscript{135}

Basel III is an opportunity as well as a challenge for banks. It can be an opportunity as it provides a solid foundation for the next developments in the banking sector, and it can ensure that past excesses are avoided. And the challenges are that Basel III is changing the way that banks address the management of risk and finance. The new regime seeks much greater

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\textsuperscript{133} Released on December 2010.
\textsuperscript{135} www.bis.org. Accessed on 17\textsuperscript{th} June, 2012.
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integration of the finance and risk management functions. However, the adoption of a more rigorous regulatory stance might be hampered by a reliance on multiple data silos and by a separation of powers between those who are responsible for finance and those who manage risk.

The new emphasis on risk management that is inherent in Basel III requires the introduction or evolution of a risk management framework that is as robust as the existing finance management infrastructures. And also being a regulatory regime, Basel III in many ways provides a framework for true enterprise risk management, which involves covering all risks to the business.\footnote{Adrian Blundell-Wignall and Paul Atkinson, ‘Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity’, vol. 2, OECD Journal and Financial Markets Trends, 2010, p.7.} A stringent approach to liquidity risk supervision is indeed necessary, rather new in the regulatory framework. In both Basel I and Basel II, liquidity risk received only limited attention.\footnote{The entire Basel framework looked only at the asset side of the balance sheet. Risks arising from the liability side including liquidity risk alongside other risks, such as interest rate risk of the banking book, are not subject to any regulatory capital requirement. They are instead disciplined under pillar 2.} In the regulator’s view the new requirements will have to be stringent concerning capital and liquidity resources which should be such that the financial system must have the strength to withstand a crisis of the size and persistency without public support.

The Accord calls for new liquidity requirement\footnote{To promote the short-term resilience of the liquidity risk profile of banks the liquidity Ratio or requirement is developed by the Basel. It does this by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted easily and immediately in private markets into cash to meet their liquidity needs.}, building differentiated incentives to traditional banking vs. speculative trading, raising new medium and long term finance, risk building, etc.

3.7.1. Challenges of Basel III
The first challenge which the banks will face is consolidate a clean exposures, liabilities, counterparties and market data in a centralized risk data. All portfolios contractual and behavioural cash flows should be made available and banks should have the ability to stress those and produce liquidity gap analysis according to various scenarios.

Liquidity Coverage Ratio (LCR) buffer eligibility and haircut rules rely on external ratings, and Basel classification of counterparties and standardized credit risk weights is usually available in risk specific system. The next challenge banks face is interfacing is merging their current risk and finance systems to meet the new Basel III Liquidity Risk Ratio requirements. The funding concentration monitoring requirement will require banks to put in place a clean hierarchical referential of counterparties for consolidating their liabilities.

3.7.2. Basel III and India

The RBI has released on its website, draft guidelines outlining proposed implementation of Basel III capital regulation in India. These guidelines are in response to the comprehensive reform package entitle ‘Basel III a global regulatory framework for more resilient banks and banking systems’ of the BCBS.139

The major highlights of the draft guidelines being Minimum Capital Requirements to be changed accordingly, transitional arrangements to be made and enhancing risk coverage. It is proposed that the implementation period of

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minimum capital requirements and deductions from Common Equity will begin from January 1, 2013 and be fully implemented as on March 31, 2017.

Capital conservation buffer requirement is proposed to be implemented between March 31, 2014 and March 31, 2017. The implementation schedule as indicated will be finalized taking into account the feedback received on guidelines.

Instruments which no longer qualify as regulatory capital instruments will be phased out during the period beginning from January 1, 2013 to March 31, 2022.140

3.7.3. Challenges to Indian Banks after Adopting Basel III

The feature of additional capital requirements, will pose a challenge for the Indian banks though, the overall capital level of the banks will see an increase. Another, challenge is re-structuring the assets of some of the banks would be a tedious process, since most of the banks have poor asset quality leading to significant proportion of Non-Performing Asset (NPA).

This also may lead to mergers and acquisitions, which itself would be loss of capital to entire system. The new norms of the RBI seem to favour the large banks that have better risk management and measurement expertise, who also have better capital adequacy ratios and geographically diversified portfolios. The smaller banks are also likely to be hurt by the rise of weightage of interbank loans that will effectively price them out of the market. Thus, banks will have to restructure themselves if they are to survive in the new

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environment. Improved risk management and measurement aim to give impetus to the use of internal rating system by the international banks.\textsuperscript{141}

The technology infrastructure in terms of computerization is still in a nascent stage in most Indian banks. Computerization of branches, especially for those banks, which have their network spread out in far-flung areas, will be a daunting task. Penetration of information technology in banking has been successful in the urban areas, unlike in the rural areas where it is significant. Experts say that dearth of risk management expertise in the Asia Pacific region will serve as a hindrance in laying down guidelines for a basic framework for the new capital accord. An integrated risk management concept, which is the need of the hour to align market, credit and operational risk, will be difficult due to significant disconnect between business, risk managers and IT across the organizations in their existing set-up. Implementation of the Basel III will require huge investment in technology.

3.8. Conclusion

Basel Accords will bring about great advances in risk measurement of banks. It will also benefit financial institutions by providing systems to measure capital more closely to their economic capital. The development of Basel Capital Accord, while not always be optimal, but indeed will contribute to raising awareness of banks capital level and risk profile. Capital regulation has become the leading factor for financial regulation and benchmark for regulatory action.

\textsuperscript{141}More and more banks may have to use internal models developed in house and their impact is uncertain. Most of these models require minimum historical bank data that is a tedious and high cost process as most Indian banks do not have such a database.

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One of the main objectives of the Basel Committee’s work, since its inception, has been to create a level playing field for financial institutions. To enable large and complex institutions to accurately measure their capital against their risk profile has been the objective for Basel. But it all depends on how a country adopts to the Accord. The cost of adopting is high, but the risk involved is also high, which is business reality. For India and other developing countries adopting Basel is an opportunity to outshine other emerging markets and to boost their reputation. The cost will be worthwhile as it will develop a risk sensitive culture among banks which is most desirable benefit of Basel Accord.

Still what bothers more is the liberalisation of service enhances the risk of security of banking transaction. Worthwhile is also to note that the crimes due to liberalisation of services have increased manifold with the advent of electronic banking. Hacking, frauds, phishing, ATM frauds, cheque frauds, embezzlement, have all pooled into the system. Detecting these crimes and punishing the offenders is an expensive and difficult job. The loss to the banking firm in case of these crimes is much bigger than the traditional crimes. And that such loss occurs at large to the nation’s economy. Hence, the next chapter deals with the liberalisation of banking services and it’s after effects.