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Exam Code : IB

Insurance and Banking

SEMESTER V

BACHELOR OF BUSINESS ADMINISTRATION

BLOCK - 2

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BACHELOR OF BUSINESS ADMINISTRATION

INSURANCE AND BANING

DETAILED SYLLABUS

BLOCK - 2

UNIT 9. Banker Customer Relationships

Definition of Banker and Customer, Relationships between Banker and Customer, Relationship of Debtor and Creditor, Relationship of Creditor and Debtor, Relationship of Trustee and Beneficiary, Relationship of Bailee and Bailor, Relationship of Agent and Principal, Rights of Banker, Obligations of Banker, Duties of Paying Banker, Duties of Collecting Banker, Know Your Customer (KYC) Guidelines.

UNIT 10. Bank Advances

Consideration for Sound Lending, Different Forms of Advances,Consortium Advances and Secured and Unsecured Advances

UNIT 11. Negotiable Instruments

Meaning of Negotiable Instruments,Meaning and Features of a Promissory Note, Meaning and Features of a Bill of Exchange,Meaning and Features of a Cheque,Types of Cheques and Meaning and Kinds of Endorsement

UNIT 12. Ancillary Services of Banks

Safe custody of Valuables,Lockers, Remittances like RTGS/NEFT/Drafts, Fee Based Services,Selling Third Party Products,Brokerage and Demat Service and Computerization in Indian Banks

UNIT 13. Innovations in Banking Technology

Electronic Banking (E-Banking) - An Introduction, Features of E-Banking, Computerized Banking System,Banks and its Transformation andDifferent technologies Used in Banks

UNIT 14. Commercial Banks

Meaning and functions of Commercial Bank, Types of Banks, Role of Commercial Banks in Economic Development, Emerging Services in Indian Banking.

UNIT 15. Mutual Fund

Meaning of mutual fund, Constitution and Management of Mutual Fund, Buy back of securities, Conditions for buy-back of securities, Mode of Buy back of securities.

BLOCK INTRODUCTION

This course “Insurance and Banking” of B.B.A. 5th semester will focus on the different aspects of insurance and banking. In today’s world the financial sector plays and important role and within this financial sector *Banking and Insurance* has a significant role to play. Due to the increasing complexities of life there has been an increase in the demand for banking services along with the increase in insurance services to cover various commercial and personal risks. This course covers the syllabus in most easy manner, enabling the students to know the subject to the point.

This is the second block of the course ‘Insurance and Banking’. This block consists of seven units.

The ninth unit explains about the Banker Customer Relationships, Definition of Banker and Customer, Relationships between Banker and Customer, Relationship of Debtor and Creditor, Relationship of Creditor and Debtor, Relationship of Trustee and Beneficiary, Relationship of Bailee and Bailor, Relationship of Agent and Principal, Rights of Banker, Obligations of Banker, Duties of Paying Banker, Duties of Collecting Banker, Know Your Customer (KYC) Guidelines.

The tenth unit is about Bank Advances, Consideration for Sound Lending, Different Forms of Advances, Consortium Advances and Secured and Unsecured Advances

The elevnth unit explains about Meaning of Negotiable Instruments, Meaning and Features of a Promissory Note, Meaning and Features of a Bill of Exchange,Meaning and Features of a Cheque,Types of Cheques and Meaning and Kinds of Endorsement

The twelveth unit explains about Safe custody of Valuables,Lockers,Remittances like RTGS/NEFT/Drafts, Fee Based Services,Selling Third Party Products,Brokerage and Demat Service and Computerization in Indian Banks

The thirteenth unit explains Electronic Banking(E-Banking) ,Features of E-Banking,Computerized Banking System,Banks and its Transformation and Different technologies Used in Banks

The forteenth unit is about meaning and functions of Commercial Bank, Types of Banks, Role of Commercial Banks in Economic Development, Emerging Services in Indian Banking.

The fifteenth unit is about Meaning of mutual fund, Constitution and Management of Mutual Fund, Buy back of securities, Conditions for buy-back of securities, Mode of Buy back of securities.

The structure of Block 2 is as follows :

UNIT 1 : Banker Customer Relationships

UNIT 2 : Bank Advances

UNIT 3 : Negotiable Insrtuments

UNIT 4 : Ancillary Services of Banks

UNIT 5 : Innovations in Banking Technology

UNIT 6 : Commercial Banks

UNIT 7 : Mutual Fund

UNIT 9: BANKER CUSTOMER RELATIONSHIPS

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Definition of Banker and Customer

9.4 Relationships between Banker and Customer

9.4.1 Relationship of Debtor and Creditor

9.4.2 Relationship of Creditor and Debtor

9.4.3 Relationship of Trustee and Beneficiary

9.4.4 Relationship of Bailee and Bailor

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9.5 Rights of Banker

9.6 Obligations of Banker

9.7 Duties of Paying Banker

9.8 Duties of Collecting Banker

9.9 Know Your Customer (KYC) Guidelines

9.10 Let Us Sum Up

9.11 Further Reading

9.12 Answers To Check Your Progress

9.13 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- define banker and customer
- describe the various kinds of relationship between banker and the customer
- discuss the duties of the paying banker
- explain the duties of the collecting banker.

9.2 INTRODUCTION

As soon as we open an account in a bank or the banker issues a draft or we deposit our valuables in a bank, a relationship is created

with the bank at that moment. However, the relationships are not the same in all the cases. It means that for the different functions of banks, the nature of relationship between the banker and the customer varies. In this unit, we will discuss the relationships between the banker and the customer. This unit focuses on the relationship that exists between the banker and the customer in providing the different services to the customers.

Our primary concern in this unit will be to analyse the relationship that is created between a banker and a customer on different occasions. This unit will be interesting as you are going to learn the different aspects of the relationships between the banker and the customer.

9.3 DEFINITION OF BANKER AND CUSTOMER

Banker

Let us discuss the term 'banker' first. In general, bank or banker means a financial institution that accepts deposits and lends money to the needy people. It deals in money.

In this respect let us see some of the definitions of the term "banker".

According to Sir John Paget, "No person or body corporate or otherwise can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques and collect cheques crossed and uncrossed for his customers."

In the Indian context, the term "banker" has been defined by the Banking Regulation Act, 1949 as "Any company which transacts the business of banking in India."

Section 6 of the Act states the various functions which a banking company can undertake. Some of these functions are-

- The borrowing, raising or taking up of money in the form of deposits in time, current or savings accounts.
- The drawing, making, ,accepting, discounting, buying, selling, collecting and dealing in bills of exchange, promissory notes, bill of lading etc.
- Issuing letters of credit, travellers' cheques etc.

From the above discussion, it is clear that the scope of activities of a banking company is very wide. Now, it is important to discuss the essential conditions that must be fulfilled by a banker or banking company. They are-

- No individual is permitted to act as bank. Only a firm or a company is permitted to act as bank.
- The banker must accept deposits from the public for the purpose of lending or investment. Joint stock companies accepting public deposits for financing their business activities are not banking. Nidhis or societies which accept deposits from its members are not bankers.
- The deposits may be fixed, current, or savings and the current accounts must be operated through cheques.
- The deposits are withdrawable by cheque, draft, order or otherwise. The banker must refund the money when demanded by the customer.
- The word “Bank” or “Banking Company” must be added with the name of the bank to identify itself as the banking company.

Customer

Now, we will discuss the term “customer”.

‘Customer’ is defined in various ways by various experts.

According to Sir John Paget, “To constitute a customer, there must be some recognizable course or habit of dealing in the nature of regular banking business…..”.

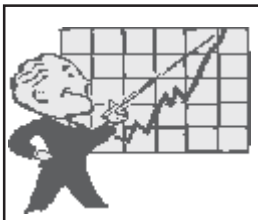
This definition has been rejected in various court cases. Therefore, to ascertain the meaning of “customer”, we have to discuss some court cases where the judgements have thrown light on the term “customer”-

- In the case of Commissioner of Taxation Vs English, Scottish and

Australian Bank (1920), the Court observed that "the word 'customer' signifies a relationship in which "duration" is not the essence…..a customer of the bank in the sense of the statute irrespective of whether his connection is of long or short standing."

- In the case of The Central Bank of India Ltd., Bombay Vs Gopinathan Nair and others, while defining the customer, the Court observed that "So far as banking business is concerned, he is a person whose money has been accepted by the banker on the footing that the banker will honour upto the amount standing to his credit, irrespective of his connection being of short or long standing."

Therefore, to become a customer, one must satisfy the condition of opening an account. The account may be a savings account or current account or fixed deposit account. The moment an account is opened, the person becomes the customer of the bank. The frequency with which the account is operated is immaterial in constituting the customer. In case of purchasing a draft or travellers' cheques etc., where opening of account is not compulsory, the person purchasing the draft or travelers' cheque does not become the customer of the bank. However, in Consumer Protection Act the term 'customer' is more liberal as it is defined by the Act as 'someone who receives a service which is paid for.'



CHECK YOUR PROGRESS

Q.1 State whether the following statements are true or false-

i. A banker cannot issue travellers' cheques.

ii. An individual can act as bank.

iii. A customer must open an account to become the customer of the bank.

iv. To consider the accountholder as customer of the bank, the accountholder must operate the account very frequently.

v. A customer can withdraw money by cheque.

9.4 RELATIONSHIPS BETWEEN BANKER AND CUSTOMER

In this section we will discuss the relationships between the banker and the customer. It has already been stated that the relationship between the banker and the customer depends on the nature of services provided by the banker. For example, when an account is opened in a bank, the relationship created is that of debtor (banker) and creditor (customer). When some valuables are deposited in the safe custody of the banker, the relationship created is that of trustee (banker) and beneficiary (customer). Let us discuss the different relationships between the banker and the customer in detail.

9.4.1 Relationship of Debtor and Creditor

You are aware that as a primary function, banks accept deposits from the public. The deposits may be fixed, current or savings deposits. Bank accepts the deposits for lending money to others or to invest in some profitable avenues. Whenever customer deposits money in a bank, the banker takes a responsibility to return the money as and when demanded by the customer along with interest. Of course, the customer must fulfill the necessary conditions in demanding the money.

When customer deposits money, in a way he lends it to the banker and the banker can use it according to his discretion to earn profit as much as he can. Moreover, at the time of returning the money, the banker can return the money in any denominations, not the same coins and notes as deposited by the customer. In this case, the relationship that is created between the banker and the customer is that of **debtor and creditor**. The banker is the debtor and the customer is the creditor.

Features of debtor- creditor relationship:

Though the relationship between the banker and the customer is that of debtor and creditor, it is not the general debtor and creditor

relationship. This relationship has certain special features, which we are going to discuss now-

- The demand for repayment of money must be made by the customer (creditor). The customer must make the demand in proper form i.e. the customer must make the demand for repayment through withdrawable forms, cheques, drafts, order or otherwise and not verbally or through telephone.
- The customer must make the demand for repayment at a particular branch i.e. the branch where the customer has the account. However, in case of bank drafts, travellers' cheques, ATM Cards etc., the bank can pay the money to the customer at some other branch.
- The customer must make the demand for repayment only during the working days and working hours of the bank.

9.4.2 Relationship of Creditor and Debtor

The relationship between the banker and the customer as debtor and creditor reverses when-

- the customer overdraws the account; and
- the banker lends money to the customer.

Overdrawing the account: In earlier units, you have come across that that the current accountholders get overdraft facility from the bank. Under this facility the accountholder can overdraw his account i.e. withdraw more money than the balance available in the account. In case the accountholder overdraws the account, the relationship between the banker and the customer gets the shape of creditor and debtor relationship- the banker is the creditor and the accountholder (customer) is the debtor. Till the overdrawn amount is returned by the customer, the relationship between the two continues to be of creditor and debtor. As soon as the overdrawn amount is returned by the customer, the relationship gets its original

shape i.e. the banker becomes the debtor and the accountholder becomes the creditor.

Lending money to the customer: When a bank sanctions a loan to a customer, the relationship between the two is that of the creditor and the debtor. The creditor (banker) charges interest on the loan till it is paid back by the customer. When the loan is paid back fully, the relationship reverses and gets the original shape of debtor (banker) and creditor (customer).

9.4.3 Relationship of Trustee and Beneficiary

Besides the debtor- creditor relationship between the banker and the customer, some other types of relationships also exist between the two, depending on the services provided by the bank. One of such relationships is that of trustee and ***beneficiary***.



Beneficiary —

The person for whom the trustee holds money or assets and performs the functions for the benefit of the beneficiary.

Perhaps you are aware that banks provide some services under which the customers can keep their valuables like jewellery, share certificate etc. in safe custody of the bank. The customer remains the owner of such valuables though they are in the custody of the banker. In this case, the banker acts as trustee and the customer is the beneficiary.

9.4.4 Relationship of Bailee and Bailor

When the customer keeps his valuable in the safe custody of the banker, the banker besides acting as trustee also acts as bailee. In that case the customer becomes the bailor. If the customer (bailor) suffers any loss due to the negligence of duty on the part of the banker (bailee), the customer can file a case in the court of law for the recovery of such loss.

9.4.5 Relationship of Agent and Principal

From our discussion on the agency functions of banks, you have come to know that banks as agents collect cheques, bills, drafts

etc. on behalf of the customer. The bank also makes payments of regular nature like, insurance premium, rent etc. on behalf of the customer. While performing these functions the bank acts as the agent of the customer and the customer is the principal. The banker (agent) performs the functions according to the instructions of the customer (principal) and for this the banker is entitled to get commission from his principal.



CHECK YOUR PROGRESS

Q2:. Identify the relationship between banker and customer-

i. Depositing cheques in the bank for collection: Bank … ……. Customer … ……..

ii. Keeping important document in the safe deposit of bank: Bank … ……. Customer … ……..

iii. Depositing money in the bank account: Bank … ……. Customer … ……..

iv. Loan availed by the customer from bank: Bank ……. Customer … ……..

v. Customer instructed the bank for payment of insurance premium: Bank … ……. Customer … …….

9.5 RIGHTS OF BANKER

You are now familiar with the various relationships of banker and customer. A banker has certain obligations to the customers. At the same time banks enjoy certain rights also. Now, we will discuss some rights of the banker in relation to the bank accounts maintained in a bank.

- **Banker's lien:** In sub section 9.4.2 we have discussed the creditor and debtor relationship between the banker and the customer, where the banker is the creditor and the customer is the debtor. This

relationship arises when an amount remains due by the customer (debtor) to the banker (creditor). The banker can exercise his right of general lien by retaining the properties of the customer till all the dues are paid by the customer. In the absence of any agreement to the contrary, the banker can retain any goods and securities for general balance of accounts. However, the banker cannot exercise this right over the goods or securities which he has received in the capacity of agent or trustee of the customer.

- **Rights of set- off:** The right of set-off is a right to adjust the accounts between two parties- creditor and the debtor. On the basis of right of set- off, the banker can adjust the credit balance in the customer's account against the amount due to the banker i.e. any debit balance in the customer's account. When a customer maintains two accounts in the same capacity, the right of set- off enables the banker to combine the two accounts and adjust the amount due from the customer. The banker can exercise this right if there is no agreement to the contrary between them. In exercising this right, the banker must serve a notice to the customer.

- **Right of appropriation:** When a debtor (customer) makes payment to a creditor (banker), the debtor can instruct the creditor to adjust the amount for discharge of a particular debt. If the debtor does not give any instruction to the creditor regarding the adjustment, the creditor has the right to appropriate the amount against any debt. The creditor must inform the debtor regarding such appropriation.

- **Rights under Garnishee Order:** Generally a banker has the obligation to honour the cheques of his customer. But in case a ***garnishee order*** is issued by the court, the banker cannot make any payment from the account of the customer. The obligation of the banker to honour the cheques stand suspended in that case.

Let us see how a garnishee order can affect the relationship between



Garnishee Order —

An order issued by the court on the banker restricting the banker not to make any payment from his customer's account.

the banker and the customer. Suppose Mr. A is the customer of SBI. He has taken a loan from his friend Mr. B. But Mr. A fails to repay the loan to Mr. B and as a result Mr. B files a case against Mr. A. Now Mr. B requests the court to issue an order on the bank of Mr. A directing the banker (SBI) not to make any payment from the available balance in the account of Mr. A. If the court issues such an order, it is known as 'Garnishee Order'. Here, Mr. A (debtor) is known as 'judgement debtor', Mr. B (creditor) is known as 'judgement creditor' and the SBI is known as 'garnishee'.

The garnishee order is issued in two phases. First, 'order nisi' is issued directing the garnishee (banker) not to make any payment from the account of the garnishee debtor. The garnishee is asked to give his reply in the court whether the funds in the account of the garnishee debtor can be appropriated towards the payment of the particular debt in question. If the garnishee has no objection then in the second phase the court issues the 'order absolute' i.e. the garnishee order, to make the payment to garnishee creditor to satisfy the debt from the account of the judgement debtor. Then the banker's obligation to the customer (garnishee debtor) is discharged to that extent.

9.6 OBLIGATIONS OF BANKER

As a consequence of banker- customer relationship, the banker enjoys some rights, which we have discussed in the above section. Now, we will discuss the obligations of the banker which arises because of the banker- customer relationship. They are-

- **Obligations to honour the cheques:** You know that the banker is required to make payment to the customer when the customer makes a demand. The banker is under legal obligations to honour the cheques of the customer as and when they are presented for payment. If the banker fails to meet his obligation, he will be responsible for any loss suffered by the customer due to non-payment of cheque. However, this obligation of the banker arises on the fulfillment of certain conditions like,

- the customer must have sufficient funds in the account;
- the funds should be free from any lien;
- the cheque should fulfill all the legal requirements, etc.

- **Obligation to maintain secrecy of account:** Another obligation of the banker is that he should maintain the secrecy of his customer's account. If the information of customer's account is disclosed, he may suffer loss. But the banker can disclose the state of affairs of customer's account under certain circumstances like, when:
  - the law demands the disclosure of the account information;
  - the customer gives consent for such disclosure;
  - disclosure of account information is necessary in the public interest, etc.



CHECK YOUR PROGRESS

Q3: Fill in the blanks-

i. Lien is a right of the ……

ii. A garnishee order is issued by the ……

iii. Right of set off is a right to adjust the accounts between the …… and the ……..

iv. Honouring of cheques of customers is the ……obligation of the banker.

9.7 DUTIES OF PAYING BANKER

You know that a banker has the obligation to return the money to the customer, when it is demanded by the customer. The banker receives the money from the customer as deposit. Therefore, the banker must make the payment of the cheques drawn by the customer. The banker, who is under obligation to pay customers' cheques, is known as paying banker.

While making payment, the paying banker must be cautious. This is because he is legally liable if he pays a cheque when the customer

has insufficient fund in his account. At the same time, if he does not pay a cheque when the customer has sufficient funds in the account, he will be held responsible for any loss suffered by the customer for the wrongful act of the banker. Thus, the paying banker must be careful in honouring the cheques of the customer.

In this connection, let us discuss the duties of the paying banker. The duties include the precautions that the paying banker must take at the time of honouring the customers' cheques.

Duties or precautions of paying banker-

- On receiving the cheque, the paying banker must see that the cheque must be in the proper form as supplied by the banker. The cheque should not be torn or mutilated.
- The paying banker must see that the account against which the cheque has been drawn is maintained in the same branch. If the cheque is drawn against an account which is maintained in some other branch of the bank, the paying banker should refuse to pay the amount.
- The paying banker must be cautious regarding the time of presentation and payment date of the cheque. A cheque must be presented for payment within the normal business hours of the bank. Moreover, the banker must see the date for payment. Because a cheque can be honoured only on the date of payment as mentioned on the cheque or within six months from that date. At the same time, a cheque without date or a post- dated cheque before the due date can not be paid.
- Another aspect that the paying banker must observe is that the amount of the cheque must be written both in figures and in words and they must be similar.
- The paying banker must be cautious about the material alteration of the cheque. Material alteration means altering the contents of the cheque to make it invalid. If such material alteration is visible, the banker can make the payment of the cheque only after getting

full signature of the customer at the places of material alteration.

- Signature of the customer is another important aspect where the banker must exercise due care. The signature of the customer on the cheque must be similar with the specimen signature that he has given at the time of opening the account.
- The paying banker must also see whether the cheque is an open cheque or a crossed cheque and accordingly make the payment. The paying banker must also be careful about the validity of the endorsement, if any, on the cheque.



CHECK YOUR PROGRESS

Q4: State two duties of the paying banker.

i. .....

.....

ii. .....

.....

9.8 DUTIES OF THE COLLECTING BANKER

After discussing the duties of the paying banker, now we are going to explain the duties of the collecting banker. You are aware that banks act as agent of customers. In this respect, the bankers provide a very useful service to the customers by collecting the cheques, bills, promissory notes etc. on behalf of the customer. The banker who collects the cheques, bills etc. is called the collecting banker.

Let us discuss the duties of the collecting banker-

Duties of the collecting banker-

- Only genuine cheques should be accepted by the collecting banker.
- The collecting banker should obtain proper information from the accountholders who open accounts only for getting the cheques collected.
- The collecting banker should exercise due care in collecting the cheques which are issued by any partnership firms or trust or

body corporate and presented through the private accounts of the partner or trustee or director.

- The collecting banker should collect only the crossed cheques.
- Before accepting any cheque for collection, the collecting banker should verify the validity of the endorsement, if any.



CHECK YOUR PROGRESS

Q5: State two duties of the collecting banker.

i. .....

.....

ii. .....

.....

9.9 KNOW YOUR CUSTOMER (KYC) GUIDELINES

Let us discuss another important aspect of banker- customer relation i.e. certain guidelines that the banker has to follow when a customer opens accounts in the bank. In earlier sections we have discussed the various relationships between the customer and the banker as well as the rights and obligations of the banker. You are aware that the relationship between the banker and the customer is created as soon as the customer opens an account in the bank.

The RBI has issued certain guidelines for the management of the commercial banks. These guidelines that bankers follow are known as Know Your Customer (KYC) Guidelines.

The Reserve Bank of India has issued these guidelines with the objectives of

- Identifying depositors;
- controlling financial frauds;
- identifying money laundering and suspicious activities;
- monitoring of large value cash transactions; and
- preventing misuse of banking system for committing frauds.

The RBI has issued KYC guidelines for various aspects like, guidelines for new accounts, existing customers, risk management and monitoring procedures, record keeping etc. In this unit we will discuss the KYC Guidelines in respect of new customers and existing customers.

KYC Guidelines for new accounts-

The banker must comply with these guidelines when an individual or a corporation applies for opening account in the bank-

- The banker must verify the identity of a customer while opening an account. The new customer while opening an account in a bank may give reference of an existing accountholder or the person known to the bank as reference for his identification.
- The banker can also verify the identity of the customer on the basis of the documents, such as – passport, driving license etc. supplied by the new customer.
- The Board of Directors of the banks should establish proper procedure to verify the identification of the new customer and to monitor the suspicious nature of transactions in accounts.

KYC Guidelines for existing accounts-

In case of existing customers, it is expected that bank had adopted appropriate KYC norms while opening the accounts. In case of any default, the required norms should be completed at the earliest.



CHECK YOUR PROGRESS

Q6: State two objectives of 'Know Your Customer Guidelines'?

i. .....

.....

ii. .....

.....



9.10 LET US SUM UP

In this unit we have discussed the following-

- No individual can start banking business.
- A firm or a joint stock company can start banking business.
- The banker must accept deposits from the public for the purpose of lending or investment.
- To become a customer of the bank, one must open an account in the bank.
- The different relationships between the banker and the customer like, debtor and creditor; creditor and debtor; bailor and bailee; trustee and beneficiary etc.
- Duties of paying banker and collecting banker.
- KYC guidelines are issued by RBI with various objectives like, identification of depositors, identifying money laundering and suspicious activities etc.



9.11 FURTHER READING

1. R Parameswaran & S Natarajan (2013); *Indian Banking*; S Chand
2. I. V. Trivedi & Renu Jatana (2010); *Indian Banking System;* RBSA Publishers
3. Ujjwala Shahi (2013); *Banking in India: Past, Present & Future;*New Century Publications.



9.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i. False ii. False iii. True iv. False v. True

Ans to Q No 2:i.Bank- Agent: Customer- Principal

ii. Bank- Bailee and Trustee: Customer- Bailor and Beneficiary

iii. Bank- Debtor: Customer- Creditor

iv. Bank- Creditor: Customer - Debtor

v. Bank- Agent: Customer- Principal

Ans to Q No 3:i banker

ii. court

iii. banker; customer

iv. legal

Ans to Q No 4:

i. The paying banker must see that the cheque is in proper form.

ii. the paying banker must observe that the amount of the cheque must be written both in figures and in words and they must be similar.

Ans to Q No 5:

i. The collecting banker should collect only crossedcheques.

ii. The collecting banker should exercise due care in collecting the cheques which are issued by partnership firms or trust or body corporate and presented through the private accounts of the partner or trustee or director.

Ans to Q No 6: i. Identification of depositors; and

ii. Controlling financial frauds.



9.13 MODEL QUESTIONS

1. Define the ‘banker’.
2. Define the ‘customer’.
3. Discuss the features of debtor creditor relationship between the banker and the customer.
4. Discuss the duties of the paying banker.

5. Discuss the duties of the collecting banker.
6. Write short notes-
   i. Bailee- Bailor relationship between banker and customer
   ii. KYC Guidelines.

UNIT 10: BANK ADVANCES

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Consideration for Sound Lending

10.4 Different Forms of Advances

- 10.4.1 Loan
- 10.4.2 Cash Credit
- 10.4.3 Overdraft
- 10.4.4 Bill Discounting

10.5 Consortium Advances

10.6 Secured and Unsecured Advances

10.7 Let Us Sum Up

10.8 Further Reading

10.9 Answers to Cheek Your Progress

10.10 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the principles for sound lending by a bank;
- know the various form of loans and advances;
- explain about secured and unsecured advances; and
- point out the nature of security provided for loan.

10.2 INTRODUCTION

Granting loans and advances is one of the primary functions of commercial banks (we will discuss about commercial loan in unit 14). The major part of the deposits received by banks is lent out as loans and advances. Bank earns a large part of their income from interest on such lending. Banks act as financial intermediary by mobilizing its deposit to trade, commerce and industry for their business activities. Operation and

expansion of business and commercial activities of a commercial bank largely depend upon the ability of the bank to lend money. However lending money is not a risk free task and therefore a banker must be cautious and should take proper precautions before granting a loan. In this unit we will discuss some of the important considerations which a bank should keep in mind at the time of granting loans and advances.

10.3 CONSIDERATIONS FOR SOUND LENDING

While advancing money the banker should consider the following points-

a) **Safety** – 'Safety' is the main principle of lending. Safety means that the borrower is in a position to repay the loan, along with interest. In order to ensure safety the banker should advance loans and advances only against tangible securities. Further, the character of the borrower, his capacity to repay and his financial strength should also be considered before a loan is sanctioned.

b) **Liquidity** – Liquidity means ability to convert an investment in to cash quickly with little or no loss in value. Liquidity is the important principle of bank lending. The banker should ensure that the borrower is able to repay the loan, along with interest according to the terms of the loan contract. A banker should see that while granting loan fund is not going to be locked up for a long time. Otherwise, banker may fail to meet the claim of depositors. As far as possible the banker should grant loans and advances for shorter duration to their customer which will ensure liquidity of funds lent.

c) **Profitability** – The ultimate objective of lending is to earn profit. Main source of profit for banks is interest from loans and advances. Bank must employ their funds profitably so as to earn sufficient income to pay interest on deposit, salaries to the staff and to meet various other establishment expenses and to ensure a fair return to the owner of the bank that is shareholders.

d) **Diversification of risk** - Granting loans and advances involve a lot of risks. In order to safeguard bank's interest against unforeseen

contingencies, the banker follow the principle of diversification of risks and should invest in different areas. According to this principle banker should grant loans and advances to a wide section of borrowers. Loan should be small and given for a shorter period. Loan involving huge amount should not be granted to a single party, because in case of failure by borrower to repay the loan, the bank shall have to bear heavy loss and it will adversely affect profitability and productivity.

e) **Purpose of the loan** – Bank does not grant loan for each and every purpose, they ensure the safety and liquidity of their funds by granting loan for productive purpose. Before granting loan banker should enquire about purpose for which the loan is needed. Loan applied for productive purposes, is given more priority becaus such loan have significant impact on the borrower's earning capacity as well as welfare of the society. Loans are not advanced for speculative and unproductive purposes like social functions and ceremonies or for the repayment of a prior loan etc. Section 21 of the Banking Regulation Act empowers RBI to specify the activities for which loans and advances may or may not be given.



CHECK YOUR PROGRESS

Q 1: Mention any three principles of sound lending.

i) .....

ii) .....

iii) .....

10.4 DIFFERENT FORMS OF ADVANCES

Commercial banks lend money in four different forms. They are (a) direct loans, (b) cash credit, (c) overdraft and (d) bill discounting. These are discussed below:

10.4.1 Loan

Loan is the amount of advances made by bank to its customer. It may be with or without security. In case of loan, the bank directly makes a lump sum payment to the borrower/customer or credits his deposit account with the amount of money advanced. Loan is given for a fixed period at an agreed rate of interest. Repayment of loan may be made in installments or after a fixed period of time. Interest on loan is charged at the full amount of loan sanctioned whether the loan amount is withdrawn by customers from his account or not.

Loan system is simple as compared to cash credit and overdraft. Moreover it encourage financial discipline on the borrower as the time and repayment of installments is fixed in advance. However, loan system is inflexible and causes inconvenience as it involves more paper work. Loan may be of two types -

a) **Demand Loan:** Demand loans are repayable on demand of the bank. These are short term loan repayable within a period of 36 months but bank can recall the amount at any time. Such loan are raised normally for meeting working capital need, like purchase of raw materials, making payment of short-term liabilities etc.

b) **Term loan:** Medium and long term loan are called term loan. Term loans are granted for more than a year and repayment of such loans is spread over a longer period. Term loan is given for the purpose of starting a new business activity, renovation, modernization, expansion of existing units and for financing fixed assets.

Advantages of Loan

Following are the advantages of loan

Simple and Profitable: Loan system is simple compared to other credit system. It is profitable for banks becaus bank charge interest on the total amount sanctioned not on the ctual amount withdrawn

by the borrowers.

Review of Loan Account: Banker can review the loan account of the borrower as and when a loan is granted or renewed. If the banker is not satisfied, the account may be discontinued.

Financil Discipline: In loan system the time and the amount of instalment for repayment is fixed in advance. This bring a great degree of financial discipline.

However, loan system is suffers from some limitations such as inflexability in nature, requires more documentation, frequent renewal etc.



CHECK YOUR PROGRESS

Q 2: What are the types of loan?

i) .....

ii) .....

Q 3: Write 'true' or 'false'

(i) 'Loan' is an amount borrowed from bank.

(ii) Loan is always repaid in lump-sum.

10.4.2 Cash Credit

Cash credit is a flexible system of lending under which the borrower has the option to withdraw the funds from bank as and when required and to the extent of his needs. It is an arrangement under which the customer is allowed to borrow money up to a certain limit. Cash credit is granted on the pledge or hypothecation of goods.

'**Pledge'** means goods given as a security for payment of debt. Its primary purpose is to put the goods pledged in the possession of the lender. It ensures recovery of loan in case of failure of the borrower to repay the borrowed amount. In **'Hypothecation',** goods remain in the possession of the borrower. Bank can access the goods whenever it requires. Customer prefers hypothecation to pledge because pledge is considered to lower his prestige.

Cash credit is the most favorite mode of borrowing by the Indian business community. It is flexible in nature. Under this arrangement the banker specify a limit of loan for the customer up to which the customer is allowed to draw. Against the limit of cash credit the borrower is permitted to withdraw as and when he needs money subject to the limit sanctioned. Interest is charged on the amount actually drawn at any time and not on the full amount of credit allowed. In case of cash credit system, bank pays more emphasis on security offered than the purpose of the loan. As a result funds are diverted for other purpose or misutilised without banker's knowledge.



CHECK YOUR PROGRESS

Q 4: Find out two differences between loan and cash credit

i) .....

ii) .....

10.4.3 Overdraft

Overdraft is a short term financial assistance provided by a bank to its current account holders. It is an agreement with the bank where current account holder is allowed to draw more than the credit balance in his/her account up to an agreed amount. Customer will repay the amount as and when he will have surplus fund. In order to avail overdraft facility the customer has to make a written application to the bank and he has to open a current account with the bank. Overdraft may be granted against collateral security or against personal security of the customer to ensure safety of amount withdrawn by the customer. Interest is charged by the bank on the actual amount overdrawn by the customer and not on the maximum limit granted by the bank.

Overdraft facility is more or less similar to 'cash credit'. Cash credit and overdraft allow flexibility of borrowing, which

depends upon the need of the borrower. However cash credit is more temporary in nature. In case of overdraft customer need to open a current account but in case of cash credit separate loan account is opened in the name of the customer. Both cash credit and overdraft facility are simple and meets the short term financial needs of the customer.



CHECK YOUR PROGRESS

Q 5: Under which forms of borrowings the borrower has the option to withdraw the amount as and when required?

.....

10.4.4 Bill Discounting

Bank grants short term advances by discounting Bills of Exchange. Banks invest a good percentage of their funds in discounting bills of exchange. This method is very much popular in developed countries.

A Bills of exchange arise out of commercial transactions. Under this method the bank discounts the bill before realization that means the bank pays the amount to the customer before the due date. The net amount after deducting the amount of interest which is called discount is credited to the account of the customer. The bill so discounted is retained by the bank till its due date and is presented to the drawee on the date of maturity. While granting advances by discounting bill, the banker must satisfy himself about the honesty, integrity and credit worthiness of the drawer as well as drawee of the bill. The greatest security for a bank is that, in case the bill is dishonored on due date the amount due on bill together with interest and other charges is debited by the bank to the customer's account.

It differs from collection of bill on the ground that in case of discounting of bill the bank credits the amount of the bill in the customer's account before the actual realization of the bill. But in

case of collection of bill, the bank first collects the amount of the bill and then credits the account of the customer.

Purchasing of bill is another method of granting short term financial assistance to the customer. The bank grants loan or cash credit to the customer on the security of the bill.

10.5 CONSORTIUM ADVANCES

Commercial banks in India have recently started granting advances on consortium basis. In case of consortium advances several banks join together according to their capacities for meeting credit need of large borrowers. Such a practice is also known as 'participation financing' or 'joint financing'. A consortium advance is granted to fund a specific project.

Limited resources are one of the advantages of consortium advance. The source of bank is limited, so it may not be possible for a single bank to meet the credit need of a large borrower. Moreover banks can also diversify their risk by participating in large advances sanctioned to a particular borrower.

Consortium banks originated in the early 1960s and are predominantly found in Europe. Those were originally created to enable smaller banks to participate in international banking activities. Consortium banks are not as active as in the past; however, examples can still be found both in the U.S. and overseas.

10.6 SECURED AND UNSECURED ADVANCES

Loans and advances may be divided into two broad categories on the basis of security offered against loan. It may be secured advance or unsecured advance.

Secured advances are given on the security of some tangible assets like goods, building, securities etc. According to sec. 5(i) (n) of Banking Regulation Act, "secured advance means advance made on the security of assets the market value of which is not at any time less than the amount of such loan. Secured loans are usually the best way to obtain large amounts of money. An unsecured loan or advance means a loan or advance which is

not secured." It includes things like credit card purchases, education loans, or personal (signature) loans. Lenders take more of a risk by making such a loan, with no property or assets to recover in case of default. That is why the interest rates are considerably higher.

There are various types of securities which may be offered against loans granted, but all of those are not acceptable to the banks. The types of securities generally accepted by the bank are the following:

i) Tangible assets such as plant and machinery, motor-van, etc.
ii) Documents of title to goods, like Railway Receipt (R/R), Bills of exchange, etc.
iii) Financial Securities (Shares and Debentures)
iv) Life-Insurance Policy
v) Real estates (Land, building, etc).
vi) Fixed Deposit Receipt (FDR)
vii) Gold ornaments, jwellery etc.

Both in case of secured and unsecured advances the bank gives emphasis on credit worthiness of the borrower. But in case of unsecured advances customer is judged based on the five (5) C's of credit — character, capacity, capital, collateral, and conditions which are used to assess a borrower's/ customer's creditworthiness.



CHECK YOUR PROGRESS

Q 6: Name three securities which may be offered against loans.

.....

.....



ACTIVITY

Practical work:

(a) Visit the nearest bank and enquire about the prevailing rates of interest on different accounts and loans and advances.

(b) Familiarise yourself with the important documents, like application form for loan, including procedure involved in getting Short term and Term loan.



10.7 LET US SUM UP

In this unit we have discussed the following:

- The main activities of a commercial bank include acceptance of deposits and mobilization of funds.
- Main considerations for sound landing are Safety, Liquidity, Profitability and Diversification of risk.
- Bank grant advances to its customers in various forms like direct loans, cash credit, overdraft and bill discounting.
- Under Consortium advances several banks join together to meet the credit need of large borrower.
- Advances may be secured or unsecured. A secured advance is granted on the security of tangible assets. Unsecured advance is granted on the basis of personal security of the borrower.



10.8 FURTHER READING

1. R Parameswaran & S Natarajan (2013); *Indian Banking*; S Chand

2. I. V. Trivedi & Renu Jatana (2010); *Indian Banking System;* RBSA Publishers

3. Ujjwala Shahi (2013); *Banking in India: Past, Present & Future;*New Century Publications.



10.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) Safety ii) Liquidity iii) Profitability

Ans to Q No 2: i) Demand loan

ii) Term loan - Medium term loan and long term loan

Ans to Q No 3: i) True ii) False

Ans to Q No 4: i) In case of loan, bank advances a lump - sum amount which is onetime payment. But in case of cash credit, bank fixes a limit and customer can withdraw the amount in installments.

ii) Interest is charged on the total amount of loan granted irrespective of the use of loan amount by the customer or not. But in cash credit system, interest is charged on the actual amount withdrawn by the customer.

Ans to Q No 5: Cash credit

Ans to Q No 6: i) Tangible assets such as plant and machinery, motor-van, etc.

ii) Documents of title to goods like Railway Receipt, etc.

iii) Financial Securities like Shares and Debentures.



10.10 MODEL QUESTIONS

Q 1: What are the various considerations a banker should keep in mind before granting advances to its borrower?

Q 2: Discuss in brief the different ways of lending money by commercial banks.

Q 3: Is there any difference between 'Demand loan' and 'Term loan'? If yes, write in brief.

Q 4: What is meant by 'Secured loans'? Enumerate the types of securities generally required by banks for such loans.

Q 5: Enumerate the advantages of loans and advances raised from banks by business firms.

Q 6: What do you mean by 'cash-credit' and 'overdraft'? How do banks extend the facility of 'overdraft'?

Q 7: What do you mean by discounting and purchasing of bill. How do banks make funds available to their customers through 'discounting of bills'?

Q 8: State the meaning of:

(a) Term Loan (b) Cash Credit c) consortium advances.

*** ***** ***

UNIT 11: NEGOTIABLE INSTRUMENTS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Meaning of Negotiable Instruments

11.4 Meaning and Features of a Promissory Note

11.5 Meaning and Features of a Bill of Exchange

11.6 Meaning and Features of a Cheque

11.7 Types of Cheques

- 11.7.1 Open Cheques
- 11.7.2 Crossed Cheque

11.8 Meaning and Kinds of Endorsement

11.9 Let Us Sum Up

11.10 Further Reading

11.11 Answers To Check Your Progress

11.12 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain the meaning and types of negotiable instruments
- discuss the meaning and features of promissory note, bill of exchange and cheque
- differentiate among promissory note, bill of exchange and cheque
- explain the different types of cheques
- discuss the meaning of crossing a cheque and the various types of crossing
- discuss the meaning of endorsement and the types of endorsement.

11.2 INTRODUCTION

Individuals, businessmen and firms use various instruments to facilitate transfer of money and settlement of transactions. Perhaps you

have heard the word 'cheque' and if you have an account in a bank, probably you know the uses of a cheque. A cheque is used to transfer money from one person to another. There are some other documents which are used in business transactions to facilitate the transfer of money. These documents are called negotiable instruments. In this unit, we will discuss the meaning and different types of negotiable instruments. We will also discuss the parties involved in these negotiable instruments.

11.3 MEANING OF NEGOTIABLE INSTRMENTS

You know that a business firm can purchase and sale goods in cash or on credit. In case of cash transactions, they are immediately settled by paying cash (cash purchases) or by receiving cash (cash sales) and generally the parties have no further obligations in respect of payments. But it is not so in case of credit transactions. The purchaser who purchases goods on credit have to make payment at some later date though not immediately. The seller, in that case, writes an order (a written document) to the purchaser that he has to make payment after a specified period of time. That order has to be signed by the purchaser indicating that he has accepted the order and will make payment on the specified date. The seller retains the order with him till the specified date when the purchaser makes the payment.

But the seller instead of waiting to collect the amount on the specified date can transfer the document to some other person to meet his own business obligation. The seller can transfer the document by writing the name of the person on the back of the document and thereby instructing the purchaser to pay the amount to that person on due date. The seller must sign on the back of the document to transfer the document. At the end of the specified period, the person can collect the amount from the purchaser.

From the above discussion, it can be said that there are certain documents which facilitates the payments in business and thereby reduce the physical handling of cash. These documents are called negotiable instruments.

Hence, negotiable instruments may be defined as written documents which can be transferred from one person to another to make payments until the final payment is made. In India, the **Negotiable Instruments Act, 1881** contains the rules relating to negotiable instruments. According to Section, 13 of this Act, a negotiable instrument means "a promissory note, bill of exchange or cheque, payable either to order or to bearer whether the words "order" or "bearer" appear on the instrument or not."

According to this definition, there are only three types of negotiable instruments i.e. promissory note, bill of exchange and cheque. But some other documents like, dividend warrants, railway receipts, hundies etc. are also considered as negotiable instruments if they satisfy the conditions of a valid negotiable instrument.

Now, let us know something more about these negotiable instruments.

11.4 MEANING AND FEATURES OF A PROMISSORY NOTE

A promissory note is a negotiable instrument which contains an unconditional promise to pay a certain sum of money to a certain person or to the bearer of the instrument. Let us take an example. Suppose Shri Ram has taken a loan of Rs. 10, 000 from Shri Amal. Now, Shri Ram can write a promissory note stating "I promise to pay Shri Amal or order a sum of Rs. 10, 000, value received." Shri Ram must put his signature and it must be properly stamped to make it a valid promissory note.

Section 4, of the Negotiable Instrument Act, 1881 define a promissory note as "an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of, certain person, or to the bearer of the instrument."

Thus, a promissory note contains an unconditional promise to pay a certain sum of money only to a certain person or to his order, on a specified future date. This instrument must bear the signature of the person who promises to make payment.

Parties to a promissory note:

The main parties involved in a promissory note are-

i. **Maker or Drawer:** The person, who draws or makes the instrument, is called the maker of the promissory note. The maker promises to pay the amount specified in the promissory note. He must sign the note.

ii. **Payee:** The person to whom the amount will be paid is called the payee.

The payee may transfer the instrument before the due date to meet his business obligations. In that case, the parties will be-

- **Endorser:** The person, (the payee) who transfers the document to some other person to meet his financial obligation, is called the endorser.
- **Endorsee:** The person in whose favour the instrument is transferred is called the endorsee.

Now, let us discuss the features of a promissory note-

- **A written document:** To be a valid promissory note, it must be in writing. A verbal promise to pay is not a promissory note.
- **Unconditional promise to pay:** The promissory note must contain an unconditional promise to pay. A conditional promise to pay is not a promissory note. For example, if it is written as “I promise to pay Rs. 5, 000 to Hari, if he comes to my home”, is not a promissory note.
- **The parties must be certain:** The maker and the payee of a promissory note must be certain.
- **The amount payable must be certain:** The amount of money which is payable as promised by the maker of the promissory note, must be certain. Money means the legal tender money. If any other things other than money are promised by the maker, it is not a promissory note.
- **It must be signed by the maker:** The maker of the promissory note must put his signature on the instrument. The note may be signed by the agent of the maker but the agent must clearly state as to on whose behalf he is signing the note. The promissory note must be properly dated and stamped as per Indian Stamp Act.

- **Time of payment:** A promissory note may be payable on demand or after a fixed period of time. The promissory note which is payable on demand is called demand promissory note and those payable after a fixed period of time is called time promissory note.

The specimen of a promissory note is given below-

Rs. 10, 000 Guwahati

June 12, 2009

I, Shri Ram promise to Shri Amal or order a sum of Rupees Ten Thousand, value received.

To

Shri Amal,

Nalbari

Sd/- Ram

Stamp



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true or false-

i. Negotiable instruments can be transferred from one person to another.

ii. Promissory note is not a negotiable instrument.

iii. Promissory note contains a conditional promise to pay.

iv. A promissory note need not be signed by its maker.

v. A promissory note contains a verbal promise to pay.

11.5 MEANING AND FEATURES OF A BILL OF EXCHANGE

Let us discuss another negotiable instrument i.e. bill of exchange. Section 5 of Negotiable Instruments Act, 1881 defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument."

A bill of exchange contains an unconditional order as opposed to

unconditional promise in a promissory note. The bill must be signed by the maker, usually a creditor, who directs the debtor, to make the payment at a specified future date.

Let us take another example. Suppose, Amar has purchased goods from Hari for Rs. 5, 000 on credit. Amar is the debtor and he have to pay Rs. 5, 000 to Hari (creditor). Now, Hari can write a bill of exchange on Amar stating that Amar will pay him a sum of Rs. 5, 000 at a fixed future date. The bill must be accepted by Amar recognizing the fact that he will pay the money at the specified time. Suppose, Hari is indebted to Rakesh for Rs. 5, 000. Now, Hari can transfer the document to Rakesh, who will collect the amount from Amar on due date.

In a bill of exchange, the main parties involved are-

- **Drawer:** The person, who draws or writes the bill, is called the drawer.
- **Drawee or Acceptor:** The person, on whom the bill is drawn, is called the drawee.
- **Payee:** The person, to whom the bill will be paid, is called the payee. The drawer may himself be the payee.

Now, let us go through the features of a bill of exchange-

- The bill of exchange must be in writing.
- The bill of exchange must contain an unconditional order to pay.
- The drawer, drawee and the payee of a bill of exchange must be certain.
- The amount of money which is payable through the bill must be certain. Money means the legal tender money.
- The drawer must sign the bill. It must be properly dated and stamped as per the Indian Stamp Act.
- The drawee must accept the bill by putting his signature on the bill.
- A bill may be payable on demand or after the expiry of a fixed period of time.

The specimen of a bill of exchange is given below-

Rs. 10, 000 Guwahati

June 12, 2009

Three months after date pay Mr. ……. or order a sum of Rs. 10, 000, value received.

To

Mr. ……,

Barpeta.

Sd/- ……

Stamp

Differences between Promissory Note and Bill of Exchange

We know that both the promissory note and the bill of exchange are negotiable instruments. We have discussed the features of both these instruments. Now, let us discuss the differences between these two-

Points	**Promissory Note**	**Bill of Exchange**
1. Number of parties	There are mainly **two** parties- maker and the payee.	There are mainly **three** parties- drawer, drawee and the payee. The drawer may be the payee and in that case the number of parties will be two.
2. Promise/ Order	It contains an unconditional **promise** to pay.	It contains an unconditional **order** to pay.
3. Acceptance	Acceptance of the payee is **not required**.	The drawee **must accept** the bill.
4. Debtor/ Creditor	The maker is the **debtor**.	The drawer is the **creditor**.
5. Liability of the Maker/ Drawer	The liability of the maker is **primary and absolute**.	The liability of the drawer is **secondary and conditional** in the event of failure of the drawee.
6. Relationship of Maker/ Drawer	The maker stands in immediate relationship with the **payee**.	The drawer stands in immediate relationship with the **drawee**.



CHECK YOUR PROGRESS

Q 2: Fill in the blanks-

i) The person who draws the bill is called the ……..……..

ii) The person on whom the bill is drawn is called the …….

iii) A bill contains an unconditional ……. to pay.

iv) The …… must accept the bill.

Q 3: State two differences between a promissory note and a bill of exchange.

i) .....

ii) .....



LET US KNOW

A promissory note and a bill of exchange can be made payable on demand or after the expiry of a fixed period of time.

11.6 MEANING AND FEATURES OF A CHEQUE

You have already come across that the Negotiable Instruments Act, 1881 recognizes three instruments as negotiable instruments. They are promissory note, bill of exchange and cheque. By now you have learnt the two negotiable instruments- promissory note and bill of exchange. In this section, we will deal with the third negotiable instrument i.e. cheque. Perhaps you have seen a cheque. A cheque is made available by a bank to the accountholders to facilitate the transfer of money from one person to another.

The cheque has been defined by Section 6 of Negotiable Instrument Act as "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand."

The cheque is an unconditional order given to a banker by its customer to pay a certain amount of money to a person or the bearer of the cheque or a person authorized by the person on whose name the cheque is issued. Only an accountholder can issue a cheque to its bank. The cheque is handed over to the payee and the payee collects the money in person or

through his bank.

The main parties to a cheque are-

- **Drawer:** The person who draws the cheque is called the drawer of the cheque. The drawer is the accountholder of the bank.
- **Drawee:** The bank on whom the cheque is drawn is called the drawee. In case of cheques, the drawee is always a bank.
- **Payee:** The person on whom the cheque is payable is called the payee.

Features of a cheque:

A cheque is a negotiable instrument. But it has some special features. They are-

- A cheque must be in writing.
- The cheque must be dated.
- It contains an unconditional order to pay.
- The drawer must sign the cheque. The signature of the drawer must match with the specimen signature given by the drawer (accountholder) to the bank at the time of opening the account.
- The cheque is always payable on demand. It means the banker must pay the cheque as and when presented for payment, if all other legal conditions are fulfilled like, availability of funds in the account of the accountholder, the amount of the cheque written in words must tally with the amount written in words etc.
- A cheque is always drawn on a specified banker.
- The parties to the cheque must be certain.
- The amount of money to be payable must be certain.

The specimen of a cheque is given below-

Date …….20…….

Pay……or

Bearer Rupees…….... ……. ……Rs.

……

A/c No.

State Bank of India

Dispur

Guwahati

Let us go through the differences between cheque and bill of exchange-

Points	Cheque	Bill of Exchange
1. Drawee	A cheque is always drawn on a banker.	A bill can be drawn on any person including a banker.
2. Acceptance	A cheque does not require acceptance of the drawee.	A bill must be accepted by the drawee.
3. Payment	A cheque is always payable on demand.	A bill may be payable on demand or after the expiry of a fixed period.
4. Stamp	A cheque does not require any stamp.	A bill must be properly stamped.
5. Crossing	A cheque can be crossed.	A bill can not be crossed.



CHECK YOUR PROGRESS

Q 4: State whether the following statements are true or false-

i. The drawer must sign the cheque.
ii. A cheque is drawn on the creditor.
iii. A cheque is payable on demand.
iv. A cheque is not a negotiable instrument.
v. There are only two parties in a cheque.

11.7 TYPES OF CHEQUES

In the above specimen of the cheque, the word 'Bearer' has been written. It has a special significance so far as a cheque is concerned. If the word 'Bearer' is written on the cheque, it means the cheque can be paid to the person whose name is written on the cheque or to any person who presents the cheque to the banker for payment.

Based on this characteristic, cheques can be classified into two main groups. They are-

- Open cheques; and
- Crossed cheques

11.7.1 Open Cheques

In case of open cheques, the amount of such cheques can be collected by the payee over the counter of the bank. These cheques are of two types-

- **Bearer cheque:** The cheque which is payable to the bearer or the possessor, is called the bearer cheque. Such cheque can be transferred by mere delivery without any endorsement. For example, “Pay Ram or bearer” is a bearer cheque, where Ram or any other person who possess the cheque, can collect the amount of the cheque.
- **Order cheque:** The cheque which is payable only to a certain person (whose name appears on the cheque) or to his order, is called the order cheque. The word ‘Order’ is written instead of the word ‘Bearer’ on the cheque. The drawer can strick off the word ‘bearer’ and can write the word ‘order’ to make it an order cheque. An order cheque can not be transferred without endorsement and the paying banker takes reasonable care before making the payment of such cheque. For example, “Pay Ram or order” is an order cheque, where payment will be made only to Ram or to the person to whom Ram has endorsed the cheque.

11.7.2 Crossed Cheques

In case of crossed cheques, the amount of such cheques can not be collected over the counter of the bank. The amount of such a cheque is paid through the bank account of the payee. Hence, they are safer as compared to the open cheques.

A cheque can be crossed by drawing two parallel transverse lines across the face of the cheque with or without the words “and company” or “not negotiable” or “account payee” between the parallel transverse lines. Crossing of a cheque means paying the money to the specified person only by transferring the money to his account

and not directly (cash).

A cheque can be crossed by the-

- Drawer; or
- The holder; when the cheque is open; or
- The collecting banker.

Let us discuss the types of crossing:

- **General crossing:** Section 123 of the Negotiable Instruments Act, 1881 defines general crossing as "where a cheque bears across its face, an addition of the word "and company" or any abbreviation thereof between two parallel transverse lines simply, either with or without the words "not negotiable", that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally."

It means a cheque can be crossed generally by simply drawing two parallel transverse lines. The parallel lines are generally drawn on the left hand top corner of the cheque. The words "and company" or "not negotiable" may or may not be written in between the parallel lines.

Date …….20…….

Pay……or

Bearer Rupees…….... …… Rs.

……

A/c No.

State Bank of India

Dispur

Guwahati

Figure: General crossing of a cheque

- **Special crossing:** Section 124 of the Negotiable Instruments Act, 1881 defines special crossing as "where a cheque bears across its face, an addition of the name of a banker with or without the words "not negotiable", that addition shall be deemed a crossing and the cheque shall be deemed to be

crossed specially and to be crossed to that banker."

Thus, in case of special crossing, the name of a particular bank is written in between the parallel lines. The main implication of this type of crossing is that the amount of the cheque will be paid to the specified banker whose name is written in between the lines.

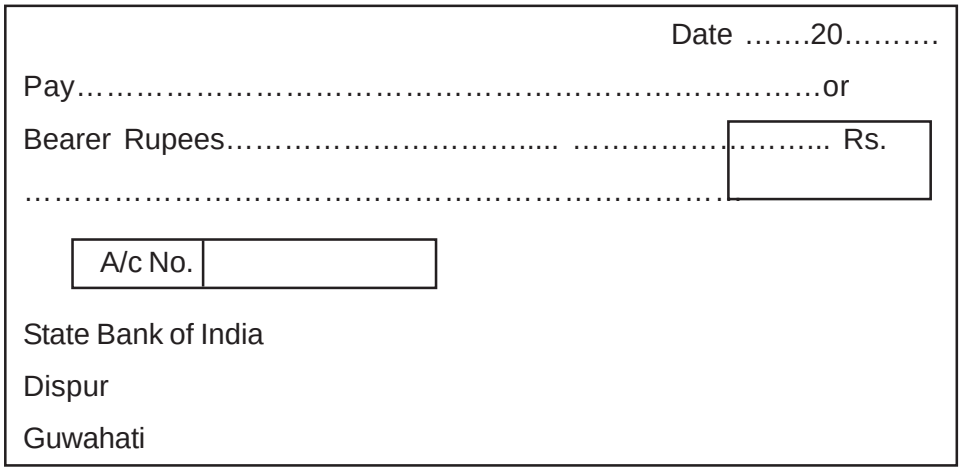


Figure: Special crossing of a cheque

- **Account payee crossing:** This type of crossing is done by adding the words 'Account Payee'. This can be made both in general crossing and special crossing. The implication of this type of crossing is that the collecting banker has to collect the amount of the cheque only for the payee. If he wrongly credits the amount of the cheque to another account, he will be held responsible for the same.
- **Not negotiable crossing:** When the words 'not negotiable' is added in generally or specially crossed cheques, it is called not negotiable crossing. If a cheque bearing 'Not negotiable crossing' is transferred, the transferee can not get a better title than that of the transferor.

11.8 MEANING AND KINDS OF ENDORSEMENT

In the above discussion, we have come to know that a negotiable instrument (promissory note, bill of exchange, cheque) can be transferred from one person to another. At this point of time, it is important to discuss

some important aspects relating to transferring of negotiable instruments. Let us start with the meaning and objective of transferring negotiable instruments.

At the first instance, a negotiable instrument is drawn by the maker or drawer. The payee of a promissory note or bill of exchange or a cheque, can transfer the instrument to settle his account with some other person instead of paying cash. Transferring a negotiable instrument implies that the person holding the instrument, transfer it with the objective of transferring the ownership of the instrument and subsequently the transferee becomes the owner of the instrument.

The negotiable instruments can be transferred through negotiation. Negotiation means transferring the ownership right in an instrument from one person to another so as to constitute that person the holder of the instrument.

A negotiable instrument which is payable to bearer can be negotiated by mere delivery. But a negotiable instrument which is payable to order can be negotiated by endorsement and delivery.

Now, what the term 'endorsement' mean? The term 'endorsement' means writing the name of the person on the back of the instrument to negotiate the instrument in favour of that person. Let us take an example. Mr. A wants to transfer a cheque to Mr. B. Now, Mr. A will write the name of Mr. B on the back of the cheque and put his signature to negotiate the cheque and then he delivered the cheque to Mr. B. This act is called endorsement. Mr. A is the endorser and Mr. B is the endorsee.

Kinds of endorsement

Let us discuss the different kinds of endorsements-

- **General endorsement:** In general endorsement, the endorser put his signature on the back of the instrument without specifying the name of the endorsee. This type of endorsement makes an order instrument payable to the bearer. General endorsement is also known as blank endorsement.
- **Special endorsement:** In this type of endorsement, the endorser adds a direction to pay the amount of the instrument to, or to the order

of, a certain person. Therefore, the bearer is not entitled to get the amount of the instrument. Special endorsement is also known as full endorsement.

- **Restrictive endorsement:** This type of endorsement restricts the right of the endorsee as regards further negotiation of the instrument. For example, Mr. A negotiate a bill as "Pay Mr. B only", is a restrictive endorsement.
- **Conditional endorsement:** If any condition is added while endorsing the instrument, it is called conditional endorsement or qualified endorsement. This type of endorsement restricts the liability of the endorser. Conditional endorsement are of the following types-
  - **Sans recourse endorsement:** When the words "sans recourse" are added as a part of endorsement, it becomes conditional endorsement. The implication of this endorsement is that the endorser is not liable to the endorsee or any subsequent holder, for the dishonour of the instrument.
  - **Facultative endorsement:** In this type of endorsement, the endorser is liable in the event of dishonour of the instrument, though the notice of dishonour is not served on the endorser as a result of facultative endorsement.
  - **Sans frias endorsement:** Sans frias means without expenses.Through sans frias endorsement, the endorser makes it clear that the endorsee or any subsequent holder need not incur any expense on his account in respect of the negotiated instrument.
  - **Liability of endorser depends upon a contingency:** In this type of endorsement, the liability of the endorser depends upon the happening of an event. If the event does not take place, the liability of the endorser does not arise. For example, if Mr. A makes an endorsement as "Pay Mr. B on his arrival"



CHECK YOUR PROGRESS

Q 5: Identify the parties in the following case-

i. Mr. X, the customer of ABC Bank draws a cheque in favour of Mr. Y, who in turn, endorses the cheque to Mr. Z.

Q 6: State whether the following statements are true or false-

i. A cheque can be negotiated by drawing two parallel lines on the cheque. (True/False)

ii. An order cheque can be paid to bearer. (True/False)

iii. In general endorsement, the endorser is not required to put his signature. (True/False)

iv. In restrictive endorsement the right of the endorser is restricted. (True/False)

v. The amount of a specially crossed cheque must be paid to the specified banker. (True/False)



11.9 LET US SUM UP

In this unit we have discussed the following-

- Negotiable instruments facilitate the transfer of money from one person to another.
- In India, the rules relating to negotiable instruments are contained in the Negotiable Instruments Act, 1881.
- According to Negotiable Instruments Act, 1881, promissory note, bill of exchange and cheque are the negotiable instruments.
- A promissory note contains an unconditional promise to pay a certain sum of money to a certain person. It must be signed by the maker.
- A bill of exchange contains an unconditional order to pay a certain sum of money. A bill must be accepted by the drawee.
- A cheque is always drawn on a specified banker and it is payable on demand.

- Open cheques are of two types- bearer cheques and order cheques.
- A cheque can be crossed by drawing two parallel transverse lines on the face of the cheque.
- Different types of crossing are – general crossing, special crossing, not negotiable crossing and account payee crossing.
- Endorsement means writing the name of the person on the back of the instrument to transfer the ownership right in favour of that person.
- The person who endorses a negotiable instrument is called the endorser and the person to whom the instrument is endorsed is called the endorsee.



11.8 FURTHER READING

1. R Parameswaran & S Natarajan (2013); *Indian Banking*; S Chand

2. I. V. Trivedi & Renu Jatana (2010); *Indian Banking System;* RBSA Publishers

3. Ujjwala Shahi (2013); *Banking in India: Past, Present & Future;*New Century Publications.



11.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i. True ii. False iii. False iv. False
v. False

Ans to Q No 2: i. drawer ii. drawee iii. order iv. drawee

Ans to Q No 3: i. There are mainly two parties in a promissory note.
There are mainly three parties in a bill of exchange.
ii. Promissory note contains an unconditional promise to pay.
Bill of exchange contains an unconditional order to pay.

Ans to Q No 4: i. True ii. False iii. True iv. False
v. False.

Ans to Q No 5: i. Mr. X- Drawer

ABC Bank- Drawee

Mr. Y- Payee and Endorser

Mr. Z – Endorsee

Ans to Q No 6: i. False ii. False iii. False iv. False

v. True.



11.11 MODEL QUESTIONS

Q 1: Define bill of exchange. Mention the parties to a bill of exchange.

Q 2: Define cheque.

Q 3: Differentiate between promissory note and bill of exchange.

Q 4: What do you mean by crossing of a cheque?

Q 5: Write short notes-

i. General crossing.

ii. Special endorsement.

*** ***** ***

UNIT 12: ANCILLARY SERVICES OF BANKS

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Safe custody of Valuables

12.4 Lockers

12.5 Remittances-RTGS/NEFT/Drafts

- 12.5.1 Definition of RTGS
- 12.5.2 About Internet Banking
- 12.5.3 About Bank Draft

12.6 Fee Based Services-

- 12.6.1 Issuing Guarantees
- 12.6.2 Letters of Credit
- 12.6.3 The Liability of Issuing Banker

12.7 Selling Third Party Products

- 12.7.1 Mutual funds
- 12.7.2 Credit Cards
- 12.7.3 Debit Cards

12.8 Brokerage and Demat Service

- 12.8.1 Brokerage
- 12.8.2 Demat Account

12.9 Computerization in Indian Banks

12.10 Let us Sum up

12.11 Further Reading

12.12 Answers to Check your progress

12.13 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- learn the meaning of various terms like RTGS/NEFT etc
- know their uses advantages and disadvantages of various banking services

- discuss the role of fee based services.
- outline the importance of computerization in banks
- discuss about the uses and importance of lockers, Safe custody of valuables.

12.2 INTRODUCTION

This unit discusses the various ancillary services of banks. Besides performing the two essential functions of accepting deposits and lending and investing its funds-that constitute the business of banking, a modern banker renders a number of ancillary services also. The ranges of these services are growing day by day which has also been a need of the customers. These services fall under two broad categories- some of these are available only to the Banker's customer's e.g. accepting valuables for safe custody while others are available to the general public e.g. issuing of banks drafts and travelers cheques.

In this unit, we shall discuss about various services rendered by the banks like safe deposits, lockers, benefits of debit card and credit card, letters of credit, Demat services its importance etc with their advantages and disadvantages.

It also explains the importance of Computerization of banks in various aspects towards general public and banks.

12.3 SAFE CUSTODY OF VALUABLES

Banks render a valuable service by accepting the valuables of their customers for safe custody. It is the foremost duty of banks to provide the service to their customers. Banks are well equipped with safes and strong rooms and hence are eminently suitable for rendering this service. There are two ways to ensure safety of the valuables of their customers.

- By accepting the valuables ,examples jewellery ,documents, title deeds, etc. for safe custody, and
- By hiring out safe deposit vaults (lockers) to the customers.

A. **Safe Custody:** Customers may entrust their valuables to the banker

for safe custody .It must be noted that when valuables, like securities, etc., are handed over to the banker for the specific purpose of safe custody, they are not subject to the general lien of the banker. A contract contrary to the right of banker's general lien comes into existence and the banker is placed in the position of a bailee. The procedure generally followed by the banker in this regard is as follows:

- The articles for safe custody may be handed over to the banker either openly or in a sealed cover or box. If the particulars are told to the banker, the same are to be recorded in the safe custody register. The banker issues receipts for the valuables deposited with him for safe custody and the signature of the customer is obtained on the counterfoil or the duplicate copy.
- At the time of the withdrawal of the valuables, the receipt issued by the bank to the customer should be duly discharged by him and surrendered to the bank. In case the receipt is lost by the customer, a letter of indemnity is to be obtained on a duplicate receipt.
- If the customer has not declared the contents of the box handed over to the banker for safe custody, the banker must record the description of the boxes, etc., in a register of boxes.
- Most importantly it must be kept in mind that safe custody facility should be given to only the banks customers.
- The customer is required to give exclusive possession over the valuables to the banker and the latter should have sole right over them.
- On the delivery of the valuables to the customer, the fact should be duly recorded in the safe custody register maintained by the bank.
- Finally, it should be also noted that the articles received for safe custody are not subject to general lien of the banker. The articles have been received for a specific purpose i.e. safe custody and therefore, they have to be returned back to the customer after this purpose is over.

The main advantage of this facility or service is that all the valuables

are in safe hands. Secondly, risk factor is less and also it can be operated by the owner only.

Rather among the major disadvantages of this service is the time consuming factor, and too many formalities in order to operate it.

B. **Liability of a Banker:** The liability of a banker in respect of a goods accepted by it for safe custody is that of a bailee and, thereof, it is subject to the provisions of section 151 and 152 of the Indian contract act. According to Section 151,"a bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would under similar circumstances take of his own goods of the same bulk, quality and values as the goods balied". While Section 152 provides that if any loss is caused to the goods in spite of such reasonable care by the bailee, he shall not be liable for the loss. Thus, a banker is bound to take reasonable care of the valuables entrusted to him. In case the banker has taken such care, he will not be liable for any loss or damage to the valuables in the absence of any contract to the contrary. The customer may hold the banker liable for loss suffered by him in each of the following cases:

(i) Negligence by the banker. As stated above, the banker can be held liable for negligence e.g. the safe deposit vaults are not as strong as they should have been, banker leaves the safe deposit vaults unlocked and the valuables are removed by someone, etc.

(ii) For conversion. In case the banker delivers the valuables accepted by it for safe custody to a wrong person, it shall be liable for the loss suffered by the customer.

(iii) Fraud by its own employees. In case any of the banker's employees concerned with safe custody if found guilty of fraud resulting in loss to the customer, the banker shall be held responsible.

C. HIRING OF SAFE DEPOSIT VAULTS: Banks provide safe deposit vaults facilities to the public at selected branches. The banks for this purpose have strong rooms generally under the ground floor which are equipped with safe deposit lockers. The lockers are of different sizes and they are hired out to the public. The rent for the lockers varies depending on the size

of the locker. The following procedure is the adopted regarding safe deposit vaults transactions:

- Any person can take or hire a safe deposit locker from the bank. However the bank generally insist that the person should maintain a saving account or a current account with the bank with an undertaking in writing that he will maintain in the account a minimum balance, say of Rs. 1,000.
- The person taking a locker a rent has to fill in a proper lease document which contains the terms and conditions of hiring a locker. An authority letter authorizing the banker to recover annual rent in respect of the locker by debit to the customer's savings/current accounts is also obtained.
- The bank maintains safe deposit vaults register in which all transactions relating to each of the rented out lockers are recorded on a separate page. The specimen signature of the hirer with his name and address are also recorded there. He is also required to choose a "password" or "code word". This acts as a additional safeguard to the hirer since it is only known to him.
- In case of a locker being hirer in joint names, specific instructions should be obtained as to the mode of operation and access to the lockers from joint lessees.
- Two keys are used for opening the lockers, one of which is kept by the hirer in his possession, while the other i.e. the master key is retained by the banker himself.
- The contents of the locker are not known to the bank. It simply records the details of the hirer's visits for the operation of the locker in the safe deposit vaults register.
- In the event of death of the hirer the contents of the locker should be delivered to the legal representative of the deceased only after his producing a valid Succession Certificate from the court.
- No locker should be leased out to minors, blind and illiterate persons.
- After the surrender of the locker, the lock of such locker should be interchanged immediately with that fixed to another vacant locker or

replaced for lock from the reverse supply. A record of all changes in respect of locks should be maintained in the “Changed Lockers Registers”.

- The manager or any other authorized person should examine the locker soon after its operation, in order to ensure that it has been properly locked by the visitor and that no article is left behind him inadvertently.
- The master key should remain in the custody of the manager or any other authorized officer during the day. It should be kept in the safe under dual control of the manager/head cashier overnight.
- The duplicate keys of the safe deposit vaults should be kept for safe custody with another branch of the bank with other bank.

12.4 LOCKERS

Bank lockers are one of the safest options to keep your jewelry and important papers safe. Safe lockers are made of high quality thick steel plates with screws fitted on them making it difficult for robbers to break open. Though there are cases of theft even in a highly guarded safe locker, it is still the best option to store your valuables. There are some advantages and disadvantages of a bank locker.

Advantages of Bank Locker: Safe lockers are probably the cheapest compared to any other form of safe deposit locker. Bank lockers are secured by insurance cover against fire and other hazards. One can nominate or appoint a family member to operate the locker in his or her absence. Total privacy is maintained in a bank locker as bank officials do not see what you keep inside your locker. Timely check can be done by the concerned customer in order to have a regular eye in their locker.

Disadvantages of Bank Locker: One of the main disadvantages of a safe locker is that one can operate only during business hours and so you need to plan in advance if they want to operate the locker. One cannot take out any contents in case of emergency. Normally, banks charge locker rent in advance for a specific period (for example, for one year). So, if the customer

vacates the locker in the middle of the year, they don't get back the refund. Banks usually insist on, depositing a sizeable sum as fixed deposits to be held with them for a longer period for letting out a locker. Sometimes the customer doesn't get the locker size of their choice. Customers probably have to use a large locker when a medium sized locker can serve your purpose. It is difficult to get lockers in rural and semi-urban areas. However, safety of bank lockers is a prime concern and one need to be extra vigilant. One should operate the locker regularly, as inactive lockers are prime targets of robbers.

Whatever be the advantages and disadvantages of a bank locker, it is still the best option than keeping your valuables in your home. One must also know RBI guidelines on bank lockers and few tips for hiring a locker which is also very important.



CHECK YOUR PROGRESS

Q1: Define Locker.

.....

.....

Q2: Give disadvantages of lockers.

.....

.....

12.5 REMITTANCES RTGS/NEFT/BANK DRAFTS

12.5.1 Definition of RTGS

RTGS or Real Time Gross Settlement is a system where the funds transfer requests are processed in real time, i.e. as soon as they are received from the remitting bank. Unlike in NEFT, the funds transfer instructions under RTGS are processed individually on order basis. RTGS is considered as the fastest and most secured means of funds transfer in India.

Through RTGS an individual can transfer funds from one bank to another within India on an immediate basis. It is ideally used for high value transactions only. There is a minimum cap of Rupees

two lakhs on the RTGS transactions. And in case of any value below that an individual will have to resort to NEFT. Although almost every bank offers RTGS facility to its customers, but these RTGS services are not available in all the branches of every bank. There are approximately 100,000 branches across India that offer RTGS services and any customer who is interested in availing it can check whether their branch offers the same or not, either by asking the branch or checking the list available on the official website of RBI.

RTGS Charges: All Inter-Bank Money Transfer services have a nominal charge attached to them. In order to avail the RTGS service the customers have to pay a certain fee in order to have their order processed. Charges for every bank vary a little but there is a uniform slab for applying the charge on payments.

The slabs are divided in two brackets: Transactions between 2 and 5 lakhs and transactions from 5 lakh onwards up to any amount. The RTGS charges follow the same slab with some further demarcations. The bracket of 2 to 5 lakhs carries a nominal charge of Rs. 25/- as existing charges for branch and Rs.5/- for transactions through internet banking channel. The bracket of 5 lakh and above carries a charge of Rs.50 as existing charges for branch and Rs.10/- for transactions through internet. In order to ensure a smooth transition of funds one has to first understand how to do RTGS transfer. Following are steps to be observed while doing RTGS.

Firstly, internet banking facility needs to be activated, the bank branch has to be contacted to do the activation then one has to Log on to the online web portal of the bank with the ID and password provided to them then they need to go to their profile and select the option of beneficiary. After that Select RTGS from the inter-bank payment options available and then select the option provided to add a beneficiary and provide the necessary details such as name, account number, address and IFSC code of the beneficiary, also click the 'accept Terms of Service (Terms & Conditions)' button followed by 'confirm'. .A high security password is sent to the mobile

number as an additional security measure. Enter this password to authorize the beneficiary. The beneficiary added is activated within time ranging from 30 minutes to a few hours depending upon the bank and security measures. Once the beneficiary account is activated, the transfers can be done instantly. To remit funds to the Inter Bank Payee through RTGS / NEFT select the 'Inter Bank Transfer' link in the 'Payments/Transfers' tab.Select the Transaction Type – RTGS or NEFT. The list of beneficiary accounts added is displayed and finally the Amount is needed to be entered and select the beneficiary to be credited from the list. And click on 'Accept Terms of Service (Terms & Conditions)' and confirm.

In case any customers faces any problems, it is advisable to consult the bank and get a representative to explain how to use RTGS funds transfer in order to ensure that there are no mistakes.

Getting to understand how to do RTGS funds transfer is helpful in the long run as everyone prefers instant money transfers, especially for big payments. In fact the RTGS service has several benefits. Some of them are as under:

Previously payments of a huge amount were made via demand draft, which could only be cleared in a period of three days. Now the same can be done within no time through RTGS, it saves paper. Without any need for physical documentation, transfers of huge sums can be made instantaneously. There is no threat of money being stolen or cheques being forged, since all the process is done online. Huge sums of money can be transferred easily, making it easier for companies to run their business smoothly. It also helps companies to manage their business capital in a much better way that there are lesser chances of counter-party defaults which in turn also ensures a better supplier- buyer relationship, as a huge sum can be transferred in one go and without any delay.

Before an effective RTGS transfer there are certain basic requirements that one needs to meet. The customer will have to furnish the following information to the bank.

Remittance amount, together with account details of the remitting customer for debiting the sum, also the name of the beneficiary bank and branch. The IFSC Number of the receiving branch, name of the beneficiary customer, account number of the beneficiary customer, sender to receiver information, if any,

In case where the funds have not been transferred successfully, the remitting customer will be informed of the same and the amount will be credited back to his account.

All banks provide the customers with an option to reach out to the branch manager if they are facing any issues with the RTGS services.

12.5.2 About Internet Banking

Internet banking marked the beginning of a new era in the banking sector as it has revolutionized the way banks operate. With Internet banking and money transfer methods like NEFT, banks have given their customers the right to manage their funds in a simplified manner. The customers are able to get complete control over your credit card and bank account, using the online banking facility. A NEFT transaction, or National Electronic Funds Transfer, allows you to carry out a one-to-one money transfer in the quickest possible time. For such a transfer, there is a need to enter the bank details of the beneficiary and the IFSC code of the bank branch.

One of the major reasons behind the popularity of Internet banking and NEFT transfer is that reputed institutions like ICICI and HDFC too are offering such facilities to customers. For making a transaction, one requires to create a user id on the official website of the banking institution. Once an account is created there is a need to add the respective ICICI IFSC code or HDFC IFSC code, depending upon the requirements. After the beneficiary is added, one is ready to make or receive payments through NEFT and Internet banking.

Benefits of NEFT and Internet Banking:

1. Safe and Effective – For a seamless movement of funds on the Internet, one could opt for NEFT as it helps one transfer any amount of money quickly.
2. Low Processing Charges – Internet banking and NEFT are flexible payment options which are very economical. For getting this facility, there is need to reimburse a huge sum of money to your bank. The processing charges are quite low and one can transfer any amount of money without any difficulty.
3. Highly Dependable – NEFT, an integral aspect of Internet banking, is a highly dependable method of making payments and receiving funds online. Most of the banks in India are regulated under the norms set by RBI and hence the Internet banking facility too is quite safe in nature.
4. Rapid Settlement – Unlike the regular banking methods of fund transfer, NEFT transfer is really quick and one can enjoy rapid settlement of accounts thereby improving the overall functionality of your business.

Disadvantages of NEFT and Internet Banking:

1. Highly Technical – One of the major drawbacks of Internet banking and NEFT transfer in India is that this is a highly technical method of funds transfer which is not easy to operate for everyone. An individual with little knowledge of computer or the Internet might not be able to operate an Internet banking account easily.
2. The Risk involved with Online Payments – Even though most of the banks in India take proper steps to secure an NEFT transaction, it is quite possible that the information might get passed on to a hacker if one is using an unsecured browser. This is one of the reasons why people across the country feel insecure and don't believe in this facility.
3. Even though Internet banking comes along with certain

disadvantages, this is one of the best and the easiest methods of carrying out financial transactions in the country.

12.5.3 About Bank Draft

For remitting money from one place to another, banks issue bank drafts or demand drafts on their branches at the place of destination.The Negotiable Instruments Act defines a bank drafts as "an order to pay money, drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand". A draft is always payable on demand. The purchaser of the draft intending to remit money, is required to pay the amount to be remitted to the banker, who thereafter issues him a draft. The purchaser sends the draft to the payee at the destination for the purpose of encashment at the drawee branch of the bank. Depending upon the amount the issuing banker charge commission for rendering this service.

PARTIES TO A BANK DRAFT:

- The drawer branch.
- The drawee branch.
- The payee.

ADVANTAGES OF BANK DRAFT:

- Bank guarantees payment: Banks are able to guarantee bank draft because the customer has already paid .To get a banker's draft, a bank customer must have funds available, and the bank will keep those funds in its own account until the payment is completed.
- Good for large transactions: For large transactions, the consequences of bounced cheque if significant. It's risky to send expensive goods or complete a deal when there's any uncertainty about a successful payment. A bank draft is a guaranteed form of payment that makes the payment much more likely to go through.
- Safety of transactions: A bank draft is a form of payment used

when safety is important. Similar to a cashier's cheque, a bank draft is safer than a personal cheque when accepting payments.

- It is fast: Standard cheques can take several business days to move through the banking system. Receiving a cheque doesn't mean actually receiving of funds. Bank draft will generally be available in the recipient's account within one business day, and it's unlikely that the bank will reverse the deposit a few days or weeks later.

12.6 FEE BASED SERVICES

12.6.1 Issuing Guarantees

Bankers usually issue guarantees of various types for their customers in favour of third parties. The guarantees issued by the bankers are mainly of two types – Money Guarantee and Performance guarantee.

In case of a Money Guarantee the banker promises to pay the money due by the customer to a third party in case of failure of the customer to pay in the due date as agreed. Such guarantees are issued for deferred payment installments in case of purchase of machinery from indigenous manufacturers.

Performance guarantees are given by the bankers in favour of the government or public bodies or in case of turn- key projects on behalf of the contractors undertaking to pay a penalty say 10% or 20% of the cost of the project in case of non-fulfilment of the contract.

The bankers should take precaution while issuing such guarantees:

a. It should obtain reliable credit reports regarding the customers for whom it is giving guarantee and these reports must be kept updated.

b. The guarantee should be given for a short period and they should not be for an indefinite period.

c. The guarantee should relate to the normal business of the customer.

d. The banker should take counter-guarantee from the customer or ask for some tangible security in support of such counter-guarantee.

12.6.2 Letters of Credit

Apart from providing appropriate mechanism for making payments arising out of trade transaction, the banks gear the machinery of commerce, especially in case of international commerce, by acting as a useful link between the buyer and the seller. Opening or issuing letters of credit is one of the important services provided by the banks for these purposes. The standing, reputation and goodwill earned by the banking institution enables it to issue instruments, known as Letters of Credit, in favour of traders and banks to meet the needs of their customers. A Letter of Credit carries a promise or an understanding by the issuing banker which is valued and honored on global basis.

By issuing or establishing a Letter of Credit, a banker requests another party (a banker or a trader) to grant a specified amount to a third party specified therein and the issuing bank himself binds to pay the money paid under the letters of credit. Letters of Credit are of two types:

i. *Traveller's Letter of Credit* issued for the convenience of the travelling public. A person who wishes to travel within the country or abroad, or intends to stay at some other places for some time, incurs great risk if he carries with him the sufficient amount of money. The money may be lost on the way or someone may steal it. Banks issue travelers letters of credit to grant protection to the travellers against such risks.; and

ii. *Letters of Commercial Credit* issued for the purpose of facilitating trade transactions. Their importance is far greater in case of international trade. Letters of commercial credit play

an important role in the trade of a country, especially in its international trade.

A Letter of Credit is a letter issued by the banker of the foreign buyer, at the letter's request, in favour of the exporter informing him that the issuing banker undertakes to accept the bills drawn in respect of exports made to the foreign buyer specified therein. In other words, a letter of credit may be described as a written intimation from the overseas buyer's bank that they have been instructed to open a credit for a certain amount of goods to be exported under certain terms and conditions.

Advantages of a Letter of Credit to the beneficiary

A Letter of Credit is an instrument which facilitates trade transactions between two parties who are not known to each other. The major advantages derived by the seller or the beneficiary of the letter of credit are as follows:

(1) Certainty of Payment and Avoidance of Risk: Though the exporter may be quite unfamiliar with the importer, the letters of credit provides him an absolute assurance that the bills of exchange drawn under the letters of credit will be honoured. The risk of dishonor of the bill is thus totally avoided because the financial standing and reputation of the opening banker (and also of the confirming banker, in case of a confirmed letter of credit) stands as an absolute security against any such risk. The exporter may execute the order with greater degree of assurance and certainty.

(2) Immediate Negotiation of the Bills is possible under Letter of credit: Bills drawn under the letters of credit are readily negotiated by the advising/confirming banker or any other banker, because of the firm undertaking given by the opening banker. The seller (or exporter) is able to realize the amount of the bill immediately by negotiating it with any banker. In the absence of a letter of credit, the bill may not be acceptable to a

banker for negotiation or may be negotiated on the basis of exporter's standing. If the bills are sent for the collection, the exporter has to wait till the amount of the bills is actually realized from the importer.

The rate charged by the negotiating banker is also the minimum if the bill is drawn under a letter of credit.

(3) Security against Exchange Restrictions: The opening banker issues a letter of credit after having been satisfied that the exchange control regulations of his own country do not impose any restriction on the transfer of money for the purpose in question. The availability of necessary foreign exchange in the importer's country for honouring the bills taken for granted. The 'transfer risks' are thus avoided and the exporter need not investigate into the foreign exchange regulations in the importer's country.

(4) Advance may be obtained: The exporter may obtain an advance from the bank on the basis of a letter of credit for the purpose of procuring and processing or manufacturing of goods to be exported.

Advantages of Letter of Credit to the Buyer (or Importer)

(1) The issuing banker lends the benefit of his own credit to the importer, who is enabled to import the goods which are otherwise not possible.

(2) The letter of credit gives an assurance to the importer that the bills of exchange drawn under the credit will be honoured only when they are strictly in accordance with the conditions laid down in the letter of credit and the documents required therein are duly enclosed.

12.6.3 The Liability of Issuing Banker

The banker issuing an irrevocable letter of credit gives a firm undertaking to the exporter that the bill drawn in terms of the letters of credit will be honoured. This commitment is subject to the

fulfillment of the conditions laid down in the letter of credit itself. If, on the other hand, the exporter supplies inferior goods or equipments and violates his agreement with importer, the liability of the issuing banker remains unaffected.

" The contractual relationship between the issuing bank and the buyer is defined by the terms of the agreement between them under which the letter opening the credit is issued; and as between the seller and the bank, the issue of the credit duly notified to the seller creates a new contractual nexus and renders the bank directly liable to the seller to pay the purchase price or to accept the bill of exchange upon tender of the documents. The contract thus created between the seller and the bank is separate from, although ancillary to, the original contract between the buyer and the seller, by reason of the bank's undertaking to the seller which is absolute. Thus the banker is not entitled to rely upon terms of the contract between the buyer and the seller which might permit the buyer to reject the goods and to refuse payment thereof and conversely, the buyer is not entitled to an injunction restraining the seller from dealing with the letter of credit if the goods are defective.

12.7 SELLING THIRD PRTY PRODUCTS

12.7.1 Mutual Funds

Whether you are a seasoned or first-time investor, mutual fund is something you should seriously consider adding to your investment portfolio. However, you should be aware of the advantages as well as possible pitfalls of this investment tool.

A mutual fund is an institutional device through which the investors pool their funds to invest in a diversified investment portfolio. This gives them the benefit of spreading and reducing risks. Mutual funds can be classified into two categories.

(a) Open-end mutual funds: In case of these of funds, the fund itself is ready to buy back the shares surrendered and sell

new shares and there is no fixed number of outstanding shares. Ordinarily, the transaction of purchase or sale is made at the net asset value calculated every now and then. The repurchase price is usually slightly lower than the selling price. The net assets value of the mutual funds increases and decreases depending upon the performance of securities in the portfolio of the mutual fund.

(b) Closed-end mutual funds: In case of these funds, the mutual fund management sells a limited number of shares. It does not stand ready to redeem or re-purchase these shares. One of the example of such a mutual fund is UTI's master-share. The shares of such a mutual fund are purchased and sold in the secondary markets.

(c) Several commercial banks in India have recently entered into the fields of mutual funds viz. SBI Mutual Fund-Magnum, Canshare Fund or Canstock Fund of Canara Bank, Swarnpushpa Mutual Fund of Indian Bank, BOI Mutual Fund of Bank of India etc. Besides UTI, GIC, Life Insurance Corporation of India have also entered this area.

The mutual Fund scheme offers various advantages like high return, easy liquidity, safety and tax benefits to the investors while it offers the bank an opportunity to collect fund from untapped areas.

Of course, the entry of commercial banks in the field of mutual fund has ended the monopoly of UTI and LIC and helped in providing stability to the stock markets, their entry can be justified only when the mutual fund schemes succeed in mobilizing additional savings and investing them as per national priorities. Commercial banks have the advantage of having a large number of branches in rural areas. It is, therefore, hoped that their initiation of mutual fund schemes will benefit a large majority of population and not only a small privileged minority living in urban areas but as a whole it will benefit the general public.

Advantages of Mutual Funds: The follwoing are some of the advantages of Mutual Funds:

a. Liquidity

Unless you opt for close-ended mutual funds, it is relatively easier to buy and exit a scheme. One can sell their units at any point (when the market is high). Do keep an eye on surprises like exit load or pre-exit penalty. Remember, mutual fund transactions happen only once a day after the fund house releases that day's NAV.

b. Diversification

Mutual funds have their own share of risks as their performance is based on the market movement. Hence, the fund manager always invests in more than one asset class (equities, debts, money market instruments etc.) to spread the risks. It is called diversification. This way, when one asset class doesn't perform, the other can compensate with higher returns to avoid the loss for investors.

c. Expert Management

Mutual fund is favored because it doesn't require the investors to do the research and asset allocation. A fund manager takes care of it all and makes decisions on what to do with your investment. He/she decides whether to invest in equities or debt and also decide on whether to hold them or not and for how long.

The fund manager's reputation in fund management should be an important criterion for an individual to choose a mutual fund for this reason. The expense ratio includes the fee of the manager too.

d. Less cost for bulk transactions

One must have noticed how price drops with increased volume, when one can buy any product. For instance, if a 100g toothpaste costs Rs. 10, you might get a 500g pack for, say, Rs. 40. The same logic applies to mutual fund units as well. If you buy multiple units at a time, the processing fees and other commission charges will be less compared to when you buy one unit.

e. Invest in smaller denominations

By investing in smaller denominations (SIP), one can get exposure

to the entire stock (or any other asset class). This reduces the average transactional expenses – and benefit from the market lows and highs. Regular (monthly or quarterly) investments as opposed to lumpsum investments give the benefit of rupee-cost averaging.

f. Suit your financial goals

There are several types of mutual funds available in India catering to investors from all walks of life. No matter whatever the income is, one must make it a habit to set aside some amount (however small) towards investments. It is easy to find a mutual fund that matches your income, expenditures, investment goals and risk appetite.

g. Cost-efficiency

Everyone has the option to pick zero-load mutual funds with less expense ratios. One can check the expense ratio of different mutual funds and choose one that fits in their budget and financial goals. Expense ratio is the fee for managing your fund. It is a useful tool to assess a mutual fund's performance.

h. Quick & painless process

One can start with one mutual fund and slowly diversify. These days it is easier to identify and handpick fund(s) most suitable. Maintaining and regulating the funds too will take no extra effort from your side. The fund manager with the help of his team of will decide when, where and how to invest. In short, their job is to consistently beat the benchmark and deliver you maximum returns.

i. Automated payments

It is common to forget or delay SIPs or prompt lumpsum investments due to any given reason. One can opt for paperless automation with their fund house or agent. Timely email and SMS notifications help to counter this kind of negligence.

j. Safety

There is a general notion that mutual funds are not as safe as bank products. This is a myth as fund houses are strictly under the purview of statutory government bodies like SEBI and AMFI. One can easily verify the credentials of the fund house and the asset manager from

SEBI. They also have an impartial grievance redressal platform that work in the interest of investors.

Disadvantages of Mutual Funds

a. Costs to manage the mutual fund

The salary of the market analysts and fund manager basically comes from the investors. Total fund management charge is one of the main parameters to consider when choosing a mutual fund. Greater management fees do not guarantee better fund performance.

b. Lock-in periods

Many mutual funds have long-term lock-in periods, ranging from 5 to 8 years. Exiting such funds before maturity can be an expensive affair. A certain portion of the fund is always kept in cash to pay out an investor who wants to exit the fund. This portion in cash cannot earn interest for investors.

c. Dilution

While diversification averages the risks of loss, it can also dilute the profits. Hence, one should not invest in more than 7-9 mutual funds at a time

As it is just read above, the benefits and potential of mutual funds can certainly override the disadvantages, if one makes informed choices. However, investors may not have the time, knowledge or patience to research and analyze different mutual funds.

12.7.2 Credit Cards

A Credit card is an instrument which provides instantaneous credit facilities to its holders to avail a variety of goods and services at the merchant outlet. It is made of plastic and hence popularly called as ‘Plastic Money’. Such cards are issued by banks to persons with incomes above certain minimum limits and are accepted by a variety of business establishments which are notified by the card-issuing bank. There are thus three parties to credit card:

(i) The issuing bank,

(ii) The card holder

(iii) The member establishments.

Leading Indian banks, such as the State Bank of India, Canara Bank, Bank of Baroda, Andhra Bank and a a few foreign banks viz. Citbank, Hongkong Bank and ANZ Grandlays Bank are the important issuers of credit cards in India. Some of them insist on the card-holder being their customer, while others do not. Similarly a few of them, specially Canara Bank, do not charge any fees for issuing credit cards, while others impose an initial enrollment fee and annual fee also. The eligibility conditions for issuing these cards prescribe certain minimum income being earned by the card holder. Such minimum income ranges between Rs. 50000 to Rs. 1 Lakh per annum. The aim of the issuer banks is to provide this facility to the growing middle income group and people above them. The card holder is issued a plastic card on which is inscribed the name of the issuing bank, the card number, the name of its holder and his/her signatures.

The issuing banks enrolls member establishments which agree to accept these cards for accepting payments for goods and services sold. They include various commercial establishments, shops, hotels, travel agencies, railways and domestic international airlines.

When a card holder makes a purchases or avails of any service at a member-establishments, he signs a charge slip. For this purpose he is identified by his signature on the credit card. The member establishment gives one copy of the charge-slip to the customer, and presents the other to the respective issuing banks, which makes payment to the member establishments, after deducting its commission which may range between 2 and 4%. In turn, the bank bills the card-holder for the full amount periodically, say monthly. The card holder is allowed to make payment in full within a specified period, say 15 days. Thus a card holder avails of credit for period ranging between 30 and 40 days. Some banks allow the card-holders to pay the bills in easy installments; some require payments of 10% within the specified period and the balance later on. Some banks

permit arrears upto 3 months involving a service charge 2% p.a. The card holder is thus allowed the faculty of "revolving credit" at no extra cost. In fact, at the time of issuance of a credit card, a limit is also prescribed upto which the card holder can avail credit on the card. As soon as a bill is paid by the card holder, he can again avail of a credit facility of similar amount.

Other Advantages to the card-holders:

(i) Some of the card issuing banks enters into tie-up arrangements with other banks for issuing cards e.g. Cancards of Canara Bank are issued by 7 other member banks. Banks tie-up with other international credit cards.

(ii) Banks permit withdrawal of cash against Credit Cards at their branches also. The foreign banks have ATMS facilities for this purpose. The withdrawals are within specified limits only and nominal interest is charged thereon. The State Bank of India provides a specially designed cheque book to the Card holders, which could be used for withdrawing cash at any of its branch. The cheque leaf is of the denomination of Rs. 500 and goes upto Rs. 2500.

(iii) Banks provide personal accident insurance also to the card holders and their family members upto certain limits.

(iv) The credit cards also enable the card holders to avail of other facilities such as booking of air tickets on phone.

(v) In case a card is lost the card holder has a limited liability usually upto Rs 1,000.

DISADVANTAGES OF CREDIT CARDS

1. One of the disadvantages of credit card is when the credit card is overdue; a person having the same has to pay a huge amount of interest for the default.
2. Secondly, Credit cards carry unique dangers they can be stolen and their numbers can be copied and also can be used to steal ones money and identity.

3. The credit cards make life easier but it can lead to over spending as for if one is not careful in using it, it can quickly lead to unexpected debt.

12.7.3 Debit Cards

Debit cards is the most convenient way of spending your money instead of carrying cash all around and then worrying about losing the same. Debit card is plastic money as it is quite often referred as and is similar to credit card but is linked to your bank account. When you make any purchase, you are supposed to swipe your card and the money is directly debited from your bank account. Though, it is similar to credit card, but in this case unlike credit card you cannot spend more than you have in your account and thus you do not increase your credit score.

It functions in two ways. Firstly like an ATM card that allows instant withdrawal of money. Secondly like a check where the money used for buying any item is deducted from your account in a day or two whenever your retailer presents the transaction to the Bank.

Debit card has some advantages and disadvantages, some of which are described below:

ADVANTAGES OF DEBIT CARDS

1. HIGHLY CONVENIENT: The most important advantage of using debit card is its convenience to use. The transaction involving the debit card is instantaneous as the money is directly deducted from your bank account. This is more convenient as there is no need not to wait for the transaction to get over or worry about carrying enough cash to cover all your expenses.
2. HANDY CASH CARD:Debit cards are of great use but sometimes you need cash especially while roaming onto street markets, there is a need to have cash in hand for your purchases. Debit cards are capable of giving cash. Many stores also offer cash back points on use of debit cards.

3. **PIN NUMBER PROTECTION:** Debit cards usually come with a four digit pin number that is significant. One can require this pin to make any kind of purchase. The pin also protects against any probable theft. In case the card is lost, one can block the card very easily and protect it from being used further.
4. **ANYONE CAN HAVE ONE:** The prime requirement of having a debit card is a bank account. Anyone can open a bank account with any bank even with minimum deposit. Thus, having a debit card is much easier than having a credit card as approval for credit card mostly depends on your credit score and payment history. However, these things are not considered in case of debit card.
5. **STRONG BUDGETING TOOL:** The greatest advantage of having a debit card is that one cannot spend more than what they have. This prevents you from accumulating new debt for the owner.

DISADVANTAGES OF DEBIT CARDS

1. **DOES NOT HELP YOUR CREDIT SCORE:** The credit score impacts all through the life of the customer be it positive or negative. The debit card does not help one to impact the score which means one cannot build it. The importance of having higher credit score is lower interest rate and increase in the credit limit.

2. **FEES GALORE:** Banks impose various fees on debit card holders that add up to a large amount sometimes. These include monthly use charges, major overage fees and others.

3. **INSTANT MONEY MEANS INSTANT RISK:** In case someone gets hold of your card and you do not report it immediately, the thief will be able to withdraw money from your card instantly with your pin number.



CHECK YOUR PROGRESS

Q3: Give two advantages of debit cards.

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Q4: Mention two disadvantages of credit cards

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12.8 BROKERAGE AND DEMAT SERVICES

12.8.1 Brokerage

The term brokerage refers to the business that a broker is engaged in and also in the charge that a broker makes for its services. It also refers to a company that helps its clients to buy and sell investment products like stocks and bonds.

A stock brokerage firm will typically transact equities for its clients in return for a fee or commission charged on each transaction which is also known as brokerage.

Advantages of Brokerage:

One of the advantages of the brokerage is that a trained, skilled and experienced full service broker who is committed to serve its customers with best interest which can save time and energy. It also examines the financial situation and helps to develop a custom plan.

Disadvantages of Brokerage:

One of the disadvantages of the brokerage is that a price tag may represent a combination of commission and fees called transaction costs which may be much higher than it would at a discount brokerage. Again, a good service broker may be reluctant to work with investors with small nest eggs and screen them out by requiring higher minimum investments.

12.8.2 Demat account

Every shareholder must have a Dematerialized account for the purpose of transacting. It is to be known that in order to access to the Dematerialized account requires an internet password and a transaction password too. Only then can the transfers or purchases of securities be initiated, and once the transactions are confirmed and completed the purchases and sales of securities on the dematerialized account are automatically made.

Advantages of the Demat System

There are several benefits associated with the Demat system, some of which are described below:

1. It is a safe and convenient way to hold securities.
2. t ensures immediate transfer of securities.
3. There is no stamp duty on transfer of securities.
4. Risks are also associated with physical certificates such as bad delivery, fake securities, delays, thefts, etc. are eliminated.
5. There is a major reduction in paperwork involved in transfer of securities, and reduction in transaction cost, etc.
6. Even one share can be sold, not much problem exists.
7. Change in address recorded with DP and gets registered with all companies in which investor holds securities eliminating the need to correspond with each of them separately.
8. Automatic credit into demat account of shares; arising out of bonus, consolidation, merger etc. can take place.
9. Holding investments in equity and debt instruments in a single account is possible.

Some additional advantages listed as below:

Benefit to the Company: The depository system helps in reducing the cost of new issues due to lower printing and distribution costs. It increases the efficiency of the registrars and transfer agents and the Secretarial Department of the company. It provides better facilities for communication and timely services with shareholders, investors, etc. this is how it benefits the company.

Benefit to the Investors: The depository system reduces risks involved in holding physical certificates, e.g., loss, theft, mutilation, forgery, etc. It ensures transfer settlements and reduces delay in registration of shares. It ensures faster communication to investors and payment on sale of shares. It also helps avoid bad delivery problems due to signature differences, etc. No stamp duty is paid on transfer of shares. It provides more acceptability and liquidity of securities.

Benefits to Brokers: It reduces risks of delayed settlement. It ensures greater profit due to increase in volume of trading. It eliminates chances of forgery, bad delivery. It also increases efficiency of trading, profitability and confidence in investors.

Disadvantages of the Demat System: The disadvantages of dematerialization of securities can be summarized as follows:

1. Trading in securities may become uncontrolled in case of dematerialized securities.
2. It is compulsory for the capital market regulator to keep a close watch on the trading in dematerialized securities and to check that trading does not act as a detriment to investors.
3. The role of key market players in case of dematerialized securities, such as stock-brokers, needs to be supervised as they have the capability of manipulating the market.
4. There is a need of Multiple regulatory frameworks have to be followed, including the Depositories Act, Regulations and the various By-Laws of various depositories.
5. Additionally, agreements are entered at various levels in the process of dematerialization and this may be difficult for the investors.

Money transfer from one bank to another has become far more convenient with the advent of technologies assisting in a smooth online money transfer from one banking institution to another. Systems operating under Inter-Bank Transfer, such as, NEFT and RTGS have made lives easier for those who prefer to make monetary

transactions without having to physically visit a bank and yet have secure and smooth transition in making and receiving payments. And both NEFT and RTGS are monitored by the Reserve Bank of India.

12.9 COMPUTERIZATION IN INDIAN BANKS

It is being increasingly felt that the banking industry will have to mechanize and computerize its services in order to keep pace with technical advancements and innovations. Such computerization has to be undertaken at three stages simultaneously:

1. Head Office Level;
2 .Zonal and Regional Level; and
3. Branch Level.

However, in spite of all efforts, as discussed later, mechanization and computerization has not been adopted by the commercial banks to the desired extent. It is, therefore necessary to know about the advantages and limitations of computerization besides the difficulties faced by the Indian banks in effective implementation of computerization.

Advantages of Computerzation

The computerization offers the following advantages:

1. **Speedy and Better Service:** Computerization helps in carrying out various banking operations smoothly and precisely, and thus providing a better and speedy service to the customer.
2. **Change in work culture:** Computerization makes banking work more methodical and systematic. Customers gain by proper encashment of their cheques, statement of accounts and other services. Computers process voluminous data with accuracy and speed, which in turn relieves the bank's staff of this tedious job. This enables banks to utilize the energies of their staff towards productive, innovative and development areas. All this put together brings a complete change in the work culture.
3. **Up-to-date accounts:** Computerization helps the banks keeping their

house keeping function up-to-date. Balancing of books and reconciliation of inter-branch accounts, clearance of cheques, preparation of statistical returns etc. are all done with precision and speed. Thus, the bank's records remains always up-to-date.

4. **Effective management information system:** Computerization helps in developing an effective management information system through supply of timely and adequate information required by the top management for decision making and control purpose.
5. **Facing competition**: Computerization helps in facing competition by the local banks with international banks both in and outside the country. As a matter of fact without computerization these days it will become almost impossible to keep pace in the international banking world.

Computerization suffers from the following limitations:

1. **Oppositions from employees union**: The union representing bank employees from time to time have been raising their voice against introduction of computerization on the plea that besides blocking fresh employment opportunities in banks computerization may even render the existing staff surplus. To a great extent this fear of the employees has been removed through mutual consultations between the management and the staff and making them understand the vast employment opportunities otherwise offered by the computerization.
2. **Lack of personal touch:** It is feared that introduction of mechanization/ computerisation in banking operation will make the banking services impersonal. This fear is also unfounded since the customer is more interested in getting prompt and efficient service than anything else.
3. **Heavy capital expenditure:** Computerisation of courses needs heavy expenditure in terms of equipments, cool and dust-free atmosphere etc. However keeping in mind the long term advantages of computerization and better banking services, the initial investment in computerization cannot be considered as an unprofitable investment.
4. **Lack of qualified staff**: Computerisation requires sincere, educated

and qualified personnel to handle expensive and sophisticated equipments. In case the staff lacks any of the above basic qualities, the customer service would be adversely affected. However, this problem can be sorted out over a period of time if concerted efforts are made by all concerned persons to ensure efficient working of the equipments.

Difficulties faced by the banking industries:

Computerization in our country has not kept the desired pace because of the following limitations faced by the banking industries:

1. **Non-availability of experts within the banks**: Most of the bankers did not have any exposure to the technicalities of a computer system when it was decided to computerise banking operations. As such, the banks had either to take the help of some outside consultants or recruit (in their regular cadre) some experts in the area of computerization. At the same time they had to groom the available staff having suitable aptitude and academic background. This all created problems in the initial stages of computerization.
2. **Changing technology**: Computer technology is undergoing very rapid changes all over the world. The rate of technology obsolesces is very high and new products and processes are being announced regularly. A computer system purchased today may become obsolete in the next two years. This makes purchasing computer equipments a difficult management decision. This problem to some extent can be solved by adopting the policy of acquiring computer system on lease or rental basis. However, changing of hardware quite often will create problems in developing appropriate software for the purpose.
3. **Estimate of work load:** In order to make optimum utilization of computer capacity, it is necessary to make a correct estimate of the work load. The absence of any past experience and a lack of computer knowledge to the user department has made this task quite problematic
4. **Un-realistic time schedules**: There is tremendous pressure from Government in India and Reserve Bank of India to computerize banking

operations. They are keen to achieve results in much shorter time than what is possible in many cases. This puts the computer professionals to work under lot of stress and in many cases they are not in a position to adhere to the declared schedule.

5. **Lack of computer culture:** In order to get maximum benefit from the computerized system it is necessary that the users develop an appropriate for understanding the computer intricacies and computer culture. Computer culture permeates gradually into an organization through continuous work experience. Banking industries has its own distinct culture develop over the last hundred years. Of course, this culture differs marginally from bank to bank. However, one featured is common. This featured is: "resistance to charge". In order to overcome this difficulty, it is necessary that sustained efforts are made to educate the bank staff about the utility of computers through all available means.

6. **Lack of infrastructural facilities**: Effective computerization requires certain basic infrastructural facilities e.g. appropriate equipment, qualified man-power, continuous power supply, security of data and restricted access to computers. The Indian Banks lack in respects of many of these facilities. This all results in improper and under-utilization of computer facilities.



CHECK YOUR PROGRESS

Q5: Mention two advantages of demat service.

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Q6: Write two limitations of computerization in Indian Banks.

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12.10 LET US SUM UP

In this unit we have discussed about the following:

1. There are two ways to ensure safety of the valuables of their customers.
   a. By accepting the valuables ,examples jewellery ,documents, title deeds, etc. for safe custody, and
   b. By hiring out safe deposit vaults (lockers) to the customers.
2. Bank lockers are one of the safest options to keep your jewelry and important papers safe.
3. RTGS or Real Time Gross Settlement is a system where the funds transfer requests are processed in real time, i.e. as soon as they are received from the remitting bank.
4. With Internet banking and money transfer methods like NEFT, banks have given their customers the right to manage their funds in a simplified manner. The customers are able to get complete control over your credit card and bank account, using the online banking facility. A NEFT transaction, or National Electronic Funds Transfer, allows you to carry out a one-to-one money transfer in the quickest possible time.
5. The Negotiable Instruments Act defines a bank drafts as “an order to pay money, drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand”.
6. The guarantees issued by the bankers are mainly of two types – Money Guarantee and Performance guarantee.
6. Opening or issuing letters of credit is one of the important services provided by the banks for these purposes. The standing, reputation and goodwill earned by the banking institution enables it to issue instruments, known as Letters of Credit, in favour of traders and banks to meet the needs of their customers.
7. A mutual fund is an institutional device through which the investors pool their funds to invest in a diversified investment portfolio.

8. A Credit card is an instrument which provides instantaneous credit facilities to its holders to avail a variety of goods and services at the merchant outlet.
9. Debit cards is the most convenient way of spending your money instead of carrying cash all around and then worrying about losing the same. Debit card is plastic money as it is quite often referred as and is similar to credit card but is linked to your bank account.
10. The term brokerage refers to the business that a broker is engaged in and also in the charge that a broker makes for its services.



12.11 FURTHER READING

1. S.N.Maheswari & S.K maheswari (2014);*Banking Law and Practice;*Kalyani Publishers_11 edition
2. P.N.Varshney (2017); *Banking Law and Practice;* Sultan Chand & Sons



12.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to QNo.1: Bank lockers are one of the safest options to keep your jewelry and important papers safe. Safe lockers are made of high quality thick steel plates with screws fitted on them making it difficult for robbers to break open.

Ans to QNo.2: One of the main disadvantages of a safe locker is that one can operate only during business hours and so you need to plan in advance if they want to operate the locker. One cannot take out any contents in case of emergency. Normally, banks charge locker rent in advance for a specific period (for example, for one year).

Ans to QNo.3: 1. Highly Convenient
2. Handy Cash Card

Ans to QNo.4: 1. One of the disadvantages of credit card is when the credit card is overdue; a person having the same has to pay a huge amount of interest for the default.

2. Secondly, Credit cards carry unique dangers they can be stolen and their numbers can be copied and also can be used to steal ones money and identity.

Ans Q No.5:1. It is a safe and convenient way to hold securities.

2. It ensures immediate transfer of securities.

Ans to QNo.6:

a. Lack of personal touch

b. Heavy capital expenditure



12.13 MODEL QUESTIONS

a. What is a locker?

b. What is RTGS?

c. What is NEFT?

d. What is a Brokerage?

e. What is a Letter of Credit?

f. What are the Various Advantages and disadvantages of Demat Account?

g. What are the advantages of Bank draft?

h. Write a Detailed note on role of Computerization in Indian Banks.

i. Give a note on Safety custody of valuables.

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UNIT 13: INNOVATIONS IN BANKING TECHNOLOGY

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Electronic Banking(E-Banking)– An Introduction

13.4 Features of E-Banking

13.5 Computerized Banking System

13.6 Banks and its Transformation

13.7 Different technologies Used in Banks

13.8 Let Us Sum Up

13.9 Further Reading

13.10 Answers To Check Your Progress

13.11 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will able to:

- learn about electronic banking and its features
- discuss the differnt features of e-banking
- explain about Computerized Banking System
- learn banks and its transformation
- outline different technologies used in banks

13.2 INTRODUCTION

In this unit we are going to discuss about the innovations in banking technology. Improvements in technology employ innovations in a rapid speed in our daily life. With the increased competition in banking sector and increasing demand of customer is forcing banks to provide their service online. Information technology has changed the face of the banking industry through computation.

Computerization in Indian banking sector and the use of modern innovation has increased many folds after the economic liberalization as the country's banking sector has been exposed to the worlds market.

In India, in the year 1984, a committee was formed by RBI on mechanizationin the banking industry whose chairman was Dr. C Rangarajan,Deputy Governorof RBI.Under mechanization an electronic ledger posting machine was installed which included a type writer keyboard, a printer, two floppy disc drives and a video screen. The machine was used to prepare statement on accounts for customers,maintaining primary ledgers and post transaction entries in them. The reports were submitted by the committee in 1989 and computerization began from 1993 with the settlement between bank administrationand bank employees association.In 1994 for issues related to payment system,security settlement and check clearing a committee on technology was set up in the banking industry which emphasized on Electronic Funds Transfer system.

13.3 ELECTRONIC BANKING (E-Banking) - AN INTRODUCTION

This unit highlights modern technology in banks. With the advent of technology in the banking sector and introduction of computers in Indian banks, services are provided to the customers across the country giving ease the difficulties for example, going to the bank branch, sticking to the time and working days etc. Now a days customers need not necessarily visit the bank to do banking transaction because the transactions can be done through phone, internet etc. Doing banking transaction through electronic mode is called electronic banking, popularly known as E-banking. E-banking is a recent concept and is gaining popularity among the individual as well as corporate customers. Many new concepts like anywhere banking, anytime banking, online banking, phone banking, tele-banking, personal banking, internet banking, mobile banking etc have been emerging with the use of technology and electronic programmes in the banking sector. Many financial products have also launched by the banks like ATMs, Debit cards,

Credit cards, multiple pins, electronic cheques, electronic cash etc which bringing great advantages to the customers.

13.4 FEATURES OF E-BANKING

E- Banking solutions have many features and capabilities in common, but traditionally also have some that are application specific.

A. *The common features fall broadly into several categories:*

i. Transactional (e.g., performing a financial transaction such as an account to account transfer, paying a bill, wire transfer... and applications... apply for a loan, new account, etc.)

- Electronic bill presentment and payment - EBPP
- Funds transfer between a customer's own checking and savings accounts, or to another customer's account
- Investment purchase or sale
- Loan applications and transactions, such as repayments

ii. Non-transactional (e.g., online statements, check links, cobrowsing, chat)

- Bank statements

iii. Financial Institution Administration - features allowing the financial institution to manage the online experience of their end users

iv. ASP/Hosting Administration - features allowing the hosting company to administer the solution across financial institutions

B. *Features commonly unique to business banking includes:*

i. Support of multiple users having varying levels of authority

ii. Transaction approval process

iii. Wire transfer

C. *Features commonly unique to Internet banking includes :*

Personal financial management support, such as importing data into a personal finance program such as Quicken, Microsoft Money or TurboTax. Some online banking platforms support account aggregation to allow the customers to monitor all of their accounts in one place whether they are with their main bank or with other institutions.



CHECK YOUR PROGRESS

Q1: Define e-banking

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.....

Q2: State the important features of e-banking

.....

.....

13.5 COMPUTERIZED BANKING SYSTEM

A Computerized Banking System(CBS) is designed to help banks for manage the data base.Extensive information is available at our fingertips through this System. Viewing customer data, account open and deletion, managing transaction, with drawls, balance inquiry, modifyaccount, customer information, data environment and data reports and related issues are madesimple and easy. There are custom search capabilities to aid in finding customer information andworking on customer records. This can make the system easier to navigate and to usemaximizing the effectiveness of time and other resources.

A Computerized Banking System (CBS) is a banking establishment to manage customer data.Computerized banking system for creating customer account of whole world.Also knownas computerized banking management system (CBMS), customer account recordsmanagement, customer transaction control or customer data report's system.

13.6 BANKS AND IT TRANSFORMATION

Let us now discuss some of the IT transformation in banking system.

- **MICR (Magnetic Ink Color Recognition)-**During the years 1986-88 MICR was introduced. MICR technology was used principally by the banking industry to smooth the progress of the processing of cheques and develops the routing number and account number at the bottom of a cheque. Magnetic ink character recognition (MICR) is the information that

appears at the bottom of a check. This includes the bank's routing number, the customer's account number, and the check number. The magnetic ink character recognition line is printed using technology that allows certain computers to read and process the printed information.This allowed computers to translate information (like account numbers) off printed certificates. From the late nineties all branches started handling government business to perform their functions using technology for facilitating computerization of government business.

- **IDRBT(Institute for Development & Research in Banking Technology)-** In 1996 a committee was formed by RBI in Hyderabad to upgrade technology in payment system. IDRBT was thus established as a result of recommendation of committee.The Institute for Development & Research in Banking Technology (IDRBT) is an institution exclusively focused on banking technology. Established by the Reserve Bank of India (RBI) in 1996, the institution works at the intersection of banking and technology. Under the Information Technology Act,2000;IDRBT ensured that e-banking transactions will get requisite legal protection with the commencement of Certification Authority(CA) functions.
- **IS AUDIT (information systems audit)-** An information system (IS) audit or information technology(IT) audit is an examination of the controls within an entity's Information technology infrastructure. Its purpose is to determine systems internal control design and effectiveness which included security protocols. It is the process of collecting and evaluating evidence of an organization's information systems, practices, and operations. Obtained evidence evaluation can ensure whether the organization's information systems safeguard assets, maintains data integrity, and are operating effectively and efficiently to achieve the organization's goals or objectives. Guidelines related to it were made and circulated to ensure IS audit in banks.
- **ATMs (Automated Teller Machines) -**Enabling IT channels which enhances customer service at banks in areas such as cash delivery through card based transaction settlements, Automated Teller Machines (ATMs) etc.Detail about ATM has been discussed in the next section.

- **E-BANKING (Internet Banking)-** E-banking is a safe, fast, easy and efficient electronic service that enables you access to bank account and to carry out online banking services, 24 hours a day, and 7 days a week. E-Banking allows financial institutioncustomers to conduct a secure financial transaction on website to have personal access to internet a customer must register for the service to the institution and some password will be set-up for verification of customer.With this service you save your time by carrying out banking transactions at any place and at any time, from your home or office, all you need is internet access. E-banking enables the following:

• Accurate statement of all means available in your bank account

• Statement of current account, credits, overdrafts and your deposits

• Execution of national and international transfers in various currencies

• Execution of all types of utility bill payments (electricity, water supply, telephone bills, etc..)

• Carrying out customs payments

• Electronic confirmation for all transactions executed by E-banking

• Management of your credit cards

- **RTGS (Real Time Gross Settlement)-**RTGS (Real Time Gross Settlement) is the fastest possible money transfer system through the banking channel. It is a transfer system for funds where money is being transferred from one bank to another bank on gross and real time basis. When there is no waiting period for payment transaction the settlement is in "real time". One to one basis settlement of transaction without clustering or mesh with other transaction is "gross" settlement.



CHECK YOUR PROGRESS

Q3:What is RTGS (Real Time Gross Settlement)?

……

……

Q4: Define Computerized Banking System (CBS)

……

……

13.7 DIFFERENT TECHNOLOGIES USED IN BANKS

- **Automated clearing House (ACH):** To handle cheques in clearing, house computers are used. It is difficult to clean up, substitute and establish transactions within many banks. To increase the process and wiping the operations immediately andeficiently computers are used in cleaning house. The Automated Clearing House (ACH) Network is an electronic funds-transfer system run by NACHA, formerly the National Automated Clearing House Association, since 1974. This payment system deals with payroll, direct deposit, tax refunds, consumer bills, tax payments, and many more payment servicesACH allows huge number of credit and debit transactions in batches.
- **National Automated clearing house Association (NACHA):** IThe National Automated Clearinghouse Association (NACHA) operates the Automated Clearinghouse (ACH) network, which allows companies and consumers to send payments from one account to another.t helps to transfer debit for point-of-purchase conversation check. National Payments Corporation of India, is a centralised clearing service that aims at providing interbank high volume, low value transactions that are repetitive and periodic in nature. ACH payment is being implemented by both commercial sector and government. Business is also improving by using ACH to accumulate online payment from customers than accepting debit or credit cards. NACHA and Federal Reserveestablished rules and regulations to govern ACH network.
- **Electronic Clearing Services (ECS)**:Electronic Clearing System (ECS) is an electronic method of fund transfer from one bank account to another. It is generally used for bulk transfers performed by institutions for making payments like dividend, interest, salary, pension, etc. ECS can also be used to pay bills and other charges such as payments to utility companies such as telephone, electricity, water, or for making equated monthly instalments payments on loans as well as SIP investments. In this article, we look at the working process of ECS in detail.ECS uses services of cleaninghouse to transfer funds from one to another bank account. This is

used for large transfers from one to manyaccounts or vice-versa

- **National Electronic Fund Transfer (NEFT):**It is an online system by which funds of Indian financial institutions are being transferred.National Electronic Funds Transfer (NEFT) is an Indian system of electronic transfer of money from one bank or bank branch to another.Under this Scheme, individuals can electronically transfer funds from any bank branch to any individual having an account with any other bank branch in the country participating in the Scheme.Funds below Rs 2, 00,000/-are mainly transferred by it. Structured financial messaging solutions (SFMS) wereused as a platform to make NEFT. To maintain security in NEFT public key infrastructure (PKI) technique was used.
- **Electronic Fund Transfer(EFT)**:An electronic funds transfer (EFT) is a transaction that takes place over a computerized network, either among accounts at the same bank or to different accounts at separate financial institutions.It is electronic transfer or exchange of money from one to another account. This exchange of money takes place across multiple financial institutions through computer systems to help banks offering money transfer service to their customers from any bank branch account to other branch bank.EFTs include direct-debit transactions, wire transfers, direct deposits, ATM withdrawals and online bill pay services. Transactions are processed through the Automated Clearing House (ACH) network.
- **Cards Transactions:** Debit card is an alternative method of payment of cash when transactions are being made.While using it cardholder can see available balance in account. Debit cards are widely used to withdraw cash from ATM, to purchase online on internet, making bill payments, transferring funds, etc. during opening of account banks provide free of cost debit cards.From Jan 1st 2011, RBI announced that user has to enter password on ATM for every transaction with debit card.
- **Core Banking:** To adopt core banking solutions (CBS),computerization in branches of banks is closely related with the technological development.Core banking can be defined as a back-end system that processes banking transactions across the various branches of a bank. The system essentially includes deposit, loan and credit

processing. Among the integral core banking services are floating new accounts, servicing loans, calculating interests, processing deposits and withdrawals, and customer relationship management activities.Core banking systems are aimed at empowering existing and probable customers to have a greater freedom of their account transactions. With technological evolutions, transactions are now safer, faster and less cumbersome.

- **Automated Teller Machine(ATM):** An **Automated Teller Machine** (**ATM**) is a computerized telecommunications device that provides the customers of a financial institution with access to financial transactions in a public space without the need for a human clerk or bank teller. On most modern ATMs, the customer is identified by inserting a plastic ATM card with a magnetic stripe or a plastic smartcard with a chip that contains a unique card number and some security information, such as an expiration date or CVC (CVV). Security is provided by the customer entering a personal identification number (PIN). By using an ATM, customers can access their bank accounts in order to make cash withdrawals (or credit card cash advances) and check their account balances. ATMs are known by various casual terms including *automated banking machine*, *money machine*, *cash machine*, *hole-in-the-wall*, *cashpoint* or *Bancomat* (in Europe and Russia).

The ATM was invented by Scot John Shepherd-Barron. The world's first ATM was installed in a branch of Barclays in the northern London borough of Enfield, Middlesex, in 1967. Inspiration had struck Mr Shepherd-Barron while he was in the bath.

ATMs are placed not only near or inside the premises of banks, but also in locations such as shopping centers/malls, airports, grocery stores, petrol/gas stations, restaurants, or any place large numbers of people may gather. These represent two types of ATM installations: on and off premise. On premise ATMs are typically more advanced, multi-function machines that complement an actual bank branch's capabilities and thus more expensive. Off premise machines are deployed by financial institutions and also ISOs (or Independent Sales Organizations) where there is usually just a straight need for cash, so they typically are the cheaper mono-function

devices. An ATM is typically made up of the following devices:

- CPU (to control the user interface and transaction devices)
- Magnetic and/or Chip card reader (to identify the customer)
- PIN Pad (similar in layout to a Touch tone or Calculator keypad), often manufactured as part of a secure enclosure.
- Secure cryptoprocessor, generally within a secure enclosure.
- Display (used by the customer for performing the transaction)
- Function key buttons (usually close to the display) or a Touchscreen (used to select the various aspects of the transaction)
- Record Printer (to provide the customer with a record of their transaction)
- Vault (to store the parts of the machinery requiring restricted access)
- Housing (for aesthetics and to attach signage to)

Recently, due to heavier computing demands and the falling price of computer-like architectures, ATMs have moved away from custom hardware architectures using microcontrollers and/or application-specific integrated circuits to adopting a hardware architecture that is very similar to a personal computer. Many ATMs are now able to use operating systems such as Microsoft Windows and Linux. Although it is undoubtedly cheaper to use commercial off-the-shelf hardware, it does make ATMs vulnerable to the same sort of problems exhibited by conventional computers.

- **NFINET:**Many components like servers, connecting networks, communication channels etc.are required for working of e-banking. Various service providers were established and connected in Indiaby RBI to control and monitor e-banking. Someservice of provider is INFINETwhich stands for Indian Financial Network. Services which are provided by INFINET are e-mail, transmission of inter-city cheque realization advices, electronicclearing services-debit and credit.



13.8 LET US SUM UP

In this unit we have discussed the following:

1. E-banking is a recent concept and is gaining popularity among the individual as well as corporate customers.
2. A Computerized Banking System (CBS) is a banking establishment to manage customer data.Computerized banking system for creating customer account of whole world.Also knownas computerized banking management system (CBMS), customer account records management, customer transaction control or customer data report's system.
3. The IT transformation in banking system goes through differnt phases like MICR (Magnetic Ink Color Recognition),IDRBT(Institute for Development & Research in Banking Technology),IS AUDIT (information systems audit),ATMs (Automated Teller Machines),E-BANKING (Internet Banking),RTGS (Real Time Gross Settlement)
4. Different technologies Used in banks are Automated clearing House (ACH),National Automated clearing house Association (NACHA),Electronic Clearing Services (ECS),National Electronic Fund Transfer (NEFT),Electronic Fund Transfer(EFT),Cards Transactions,Core Banking and Automated Teller Machine(ATM)



13.9 FURTHER READING

1 Pathak.B,(); *Indian Financial System;* Pearson Education, New Delhi

2 M.Y. Khan(); *Financial Services*; Tata McGrew Hill, New Delhi



13.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: E-banking is a safe, fast, easy and efficient electronic service that enables you access to bank account and to carry out online banking

services, 24 hours a day, and 7 days a week. E-Banking allows financial institutioncustomers to conduct a secure financial transaction on website to have personal access to internet a customer must register for the service to the institution and some password will be set-up for verification of customer.

Ans to Q2: The features of e-banking broadly categorised as:i. Transactional (e.g., performing a financial transaction such as an account to account transfer, paying a bill, wire transfer... and applications... apply for a loan, new account, etc.) and ii Non-transactional (e.g., online statements, check links, cobrowsing, chat)

Ans to Q3: RTGS (Real Time Gross Settlement) is the fastest possible money transfer system through the banking channel. It is a transfer system for funds where money is being transferred from one bank to an other bank on gross and real time basis.

Ans to Q4:A Computerized Banking System(CBS) is designed to help banks for manage the data base.



13.11 MODEL QUESTIONS

Q1: Define e-banking.

Q2: Discuss the differnt features of e-banking

Q3: What is Computerized Banking System(CBS)

Q4: Explain the IT transformation in banking system

Q5: Discuss the different technologies used in banks

*** ***** ***

UNIT 14: COMMERCIAL BANK

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Meaning of Commercial Bank

14.4 Functions of Commercial Bank

14.5 Types of Banks

14.6 Role of Commercial Banks in Economic Development

14.7 Emerging Services in Indian Banking

14.8 Let Us Sum Up

14.9 Further Readings

14.10 Answers To Check Your Progress

14.11 Possible Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- define commercial banks
- discuss the different functions of commercial banks
- explain the different deposit accounts through which banks collect money
- discuss the different forms of providing financial help by the banks
- describe the different types of banks
- discuss the role of commercial banks in India
- discuss the emerging services of commercial banks.

14.2 INTRODUCTION

Perhaps you have come across with the names of banks like, “State Bank of India”, “United Bank of India”, “Union Bank of India” etc. in your locality. These are a few examples of commercial banks and are the subject matter of this unit. In this unit, we will focus on the functions of these commercial banks and the role played by them in the economic development of our country. These commercial banks are the essential

components of the financial system. From pre-independence to post independent period and from the pre-liberalization to post- liberalization phases in India, these banks have successfully faced many challenges. Now they are occupying an important place in Indian economy and in our life too. Through this unit you will be able to acquire knowledge about the different functions performed by the commercial banks some of which may be found in your locality.

14.3 MEANING OF COMMERCIAL BANK

In general, Bank refers to a financial institution where we deposit our savings, from which we withdraw our money in case of emergency and take loans. But a bank can be better defined by the various functions performed by it. Let us first discuss the definition of bank as given by the Banking Regulation Act, 1949.

Sec 5(b) of the Banking Regulation Act, 1949 defines banking as “Accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques, drafts, orders or otherwise”

From this definition it is clear that a bank accepts deposits from the public and its main purpose is to invest this money in profitable avenues. The banker is under obligation to repay the money to the depositor as and when demanded by the depositor. The depositor can withdraw his money through cheques, drafts etc.

Let us see some other definitions given by different experts-

According to Crowther, “A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it”

According to John Paget, “Nobody can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheques, and (iv) collects cheques- crossed and uncrossed- for its customers”

14.4 FUNCTIONS OF COMMERCIAL BANKS

In this section we are going to discuss the various functions performed by the commercial banks. The main functions of commercial banks as shown in the following figure can be divided into:

a. Primary functions and

b. Secondary functions

Primary functions are divided into (a) Acceptance of Deposits (b) Advancing loans (c) Credit creation. The secondary functions of a bank have two functions (a) Agency functions and (b) General utility services. We are discussing these functions in more detail below:

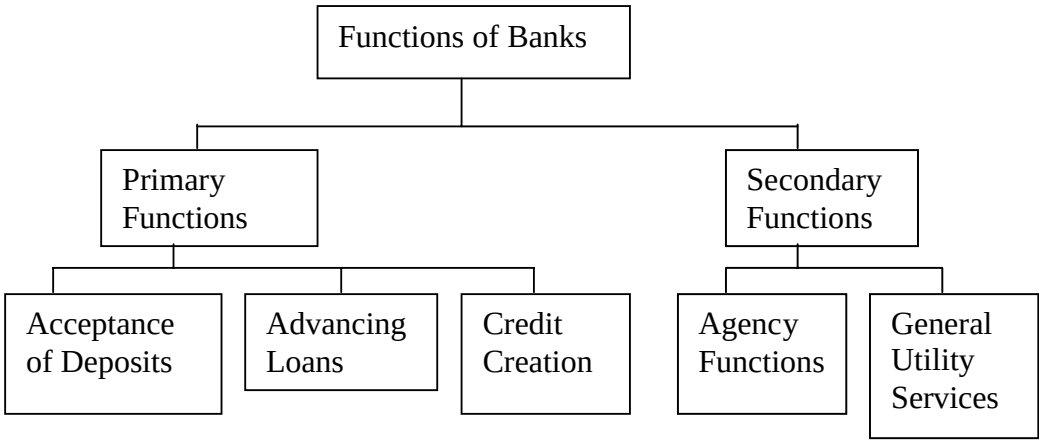


Figure 8.1: Functions of Banks

A. Primary functions: The primary functions of banks are as follows:

a) Acceptance of Deposits: The first important function of a bank is to accept deposits of money from the public. Those people who can save a portion of their income can deposit it in banks. For this purpose the banks maintain various types of accounts like fixed deposit account, current deposit account and savings deposit account etc. through which they accept deposits from the public. The banks are liable to return the amount to the depositors as and when demanded by the depositors. Those who deposit their savings in various bank accounts are known as accountholders or

depositors. They are the customers of the bank. The banks pay interest on the deposited amount to the accountholders. Moreover, it ensures safety of depositors' funds. The main deposit schemes provided by commercial banks are as follows-

- **Fixed Deposit Account:** A fixed deposit account is open for a **long period** of time covering three to five years. The bank pays higher rate of interest on this account depending on the period of time for which the account has been opened. The depositor cannot withdraw the money before the expiry of the fixed period. In case of urgency, the depositor can withdraw the money but he will lose in terms of interest. Fixed deposits are important for the commercial banks because the funds can be invested for a long period of time.

- **Current Deposit Account:** Current deposit accounts are generally opened by business organisations. The main advantage of this account is that the accountholder can withdraw more money than the balance in his account. Therefore, a businessman can withdraw more money in times of emergency. The excess amount is granted by bank as loan, known as **overdraft**. The bank charges interest on the overdrawn amount. The banks do not pay any interest on this account but charges a small amount as incidental charge.

- **Savings Deposit Account:** A savings deposit account can be opened with a bank with a **small amount** and the bank pays interest on the deposited amount. The depositor can go on depositing any amount. However, there are certain restrictions on the withdrawal of money from this account. Cheque book facility is provided with this account by the bank. The saving deposit account holder can deposit cheques, drafts, share warrants etc. drawn in his favour with the bank for collection. Collection of cheques, drafts etc. on behalf of the customer is an agency function performed by banks, which we will discuss during the discussion of Secondary

functions of banks later in this unit.

- **Recurring Deposit Account:** In this account the depositor can deposit a fixed amount of money every month. The period of deposit may vary from 1 to 10 years. At the end of the period the deposited amount along with interest is paid back to the depositor.



LET US KNOW

When a customer deposits money in a bank, it results in a debtor- creditor relationship between the banker and the customer. The banker is the debtor and the customer is the creditor. However, the demand for payment must be made by the creditor (customer) in proper manner.

a) Advancing Loans: The next important function of a bank is to provide loans and advances to the customers. After satisfying itself about the creditworthiness of the borrower, the bank provides loans to the borrower. The borrower may be an individual or a partnership firm or a company etc. Now- a- day the banks provide home loan, car loan, personal loan, educational loan etc. according to the needs of the individual borrowers. The banks also meet the short-term, medium- term and long- term credit needs of business firms. The bank charges interest on the loan amount. Generally, the interest charged by the banks on loans is more than the interest allowed by them on deposits. The banks provide financial assistance to the borrowers in various forms, like loans, cash credit, overdraft and discounting of bills of exchange.

- **Loan:** Banks grant loans to the borrowers against the security of certain assets which may be fixed assets, share certificates or savings certificates (National Savings Certificate, Fixed Deposit Receipt etc.). The loans may be for short- term i.e. covering one year or long- term i.e. covering more than one year. A loan is granted to the borrower either in cash or by credit to his account and he can withdraw the whole amount at a time or in instalments.

But he has to pay **interest on the whole amount of loan** till he repays the loan.

- **Cash credit:** It is an arrangement under which the borrower opens an account with the bank. The loan amount is credited to his account and the borrower can withdraw from his account. The main advantage of this arrangement is that the borrower can withdraw the money according to his needs. The bank charges **interest only on the amount withdrawn** by the borrower and not on the entire amount of loan.

- **Overdraft:** Overdraft facility is available only to the current account holders of the bank. Under this arrangement, the current account holders can **withdraw more money than the balance** available from his account. However, it is a temporary arrangement and the bank charges interest on the overdrawn balance. The maximum amount that the account holder can withdraw is fixed at the time of opening the account.

- **Discounting of bills:** In trade and business, when credit transactions take place, it is a common practice to draw bills of exchange by the creditor (seller) on the debtor (buyer) for the amount due. The debtor is required to accept the bill and he will make the payment on the maturity of the bill i.e. on due date. The creditor has to wait till the maturity of the bill to get the payment. Now, what the creditor can do is that instead of waiting till the maturity of the bill, he can sell the bill to the bank. The bank will make the payment to him after deducting a certain percentage as commission. On maturity of the bill, the bank collects the amount from the debtor. If the debtor fails to make payment, the bank can recover the amount from the customer (Creditor). The main advantage of this facility is that the creditor gets money immediately.

c) Credit Creation: Another function of banks is to create credit. Creation of credit is the natural outcome of the process of advancing

loans that we have discussed above. In advancing loan to the borrower, the bank opens an account in his name and credits the loan amount to that account instead of giving cash to him. The borrower can withdraw the money from the account. Thus, in the process of advancing loans, the bank **creates bank deposits** which results in increasing the money supply in the economy. This is known as credit creation function of commercial banks.

B. Secondary Functions: The secondary functions of banks are as under:

a) Agency functions: The banks perform a number of functions on behalf of the customers, known as agency functions. The various agency functions of banks are-

- **Collecting cheques, drafts, interest, rent, dividend etc**. on behalf of the customer and the amount k deposited in the account of the customer;
- **Making payment for cheques, bills, insurance premium, rent etc**. on the instructions of the customers;
- **Making purchases and sales** of shares, debentures, bonds etc. on behalf of the customers;
- **Acting as trustee** or executor for the customer;
- **Acting as financial guarantor** on behalf of the importer in foreign trade;
- **Filing income- tax return** on behalf of the customer.

b) General Utility Services: The banks provide general utility services not only to the customers but also to the general public against a fee. Some of these services are –

- **Providing locker facility** for safe keeping of valuables, important documents etc.;

- **Providing business information**. The banks collect data regarding economic conditions, financial conditions, trends in share market etc. and supply them to the customers;
- **Issuing travellers' cheques** to the travellers. The travelers are not required to carry cash with them while travelling. They can easily encash the travellers' cheques as and when required with the banks with whom the issuing bank has banking arrangements;
- **Issuing letter of credit** on behalf of the importer (buyer) in favour of the exporter (seller). This function helps the parties in settling payments in international trade;
- **Issuing credit cards:** This helps the customer to make purchases on credit from certain retail shops and service firms. The payment will be made by the issuing bank from the concerned customer's account.



LET US KNOW

Cheques in the printed form are made available by the banks to customers. The customers have to fill up the name of the payee, amount and date and have to sign before issuance of the same. The cheques are always drawn on a specified banker and the banker is under legal obligation to make the payment of the cheques, if the cheques satisfy all other conditions, like availability of funds in the customer's account, signature of the customer on the cheque tallying with the specimen signature etc.



CHECK YOUR PROGRESS

Q1: State whether the following statements are true or false-

a. The banks do not pay interest on fixed deposit accounts.(True or False)

b. Commercial banks create credit.(True or False)

c. Overdraft facility is available only in savings accounts.(True or False)

d. Primary functions of banks include agency functions and issuing of letter of credit. (True or False)

e. In cash credit arrangement the banks charge interest on the total loan amount. .(True or False)

14.5 TYPES OF BANKS

We have come to know that banks perform different types of functions. But all these banks are not of same type. The banks are of different types depending on their ownership, nature of functions, scope of operation, domicile etc.

Let us now discuss the various types of banks with their basic features-

- **Central Bank:** The central bank is the apex body of the banking and financial system. Every country has its own central bank. Perhaps you are aware that the Reserve Bank of India is the central bank of our country. It is the **monetary authority** which controls the monetary policy and the working of the commercial banks in our country. It is owned by the Government of India. The government appoints a central board headed by the Governor for its functioning. The central bank acts as government's bank.

- **Scheduled Commercial Banks:** The commercial banks which have been included in the **second schedule** of the Reserve bank of India Act, 1934 are known as scheduled commercial banks. The

banks can further be classified on the basis of ownership. They are:

- **Public sector banks:** Public sector banks are those banks in which Government of India holds majority of shares. Control of these banks is in the hands of the government. As of now there are 27 public sector banks in India. A few examples of public sector banks are – State Bank Group (State bank of India and its seven associate banks), nationalized banks like- UBI. Canara Bank, Bank of Baroda, and the Regional Rural Banks etc.

- **Private sector banks:** These banks are set up in the private sector. Government has no control on internal management and operations of these banks. After nationalization of banks in 1969 there were no private sector banks. However, in 1990, the RBI permitted opening of banks in private sector on the recommendation of the **Narasimham Committee Report**. Some of the banks in private sector are ICICI Bank, HDFC Bank, IDBI Bank, Indusind Bank, Axis Bank etc.

- **Foreign banks:** The banks which are operating in India through their branches with their head offices being established in foreign countries are known as foreign banks. The declaration of liberalization policy in 1991 speeded up the process of establishing foreign banks in India. Some of the banks operating in India are Standard Chartered Bank, HSBC Ltd., State Bank of Mauritius etc.

- **Regional Rural Banks:** Regional Rural Banks (RRBs) were established by the Government of India through the Regional Rural Banks Ordinance, 1975. The ordinance was later replaced by the **Regional Rural Banks Act, 1976**. These banks are sponsored by the public sector banks to provide a helping hand for the growth of the rural sector. The main functions of the RRBs are **to provide credit to the rural and remote areas** and **to mobilize savings**

from these areas. They operate in a specific small area comprising 2- 3 districts. The RRBs are established with an issued capital of Rs. 25 lakhs. 50 percent of the issued capital is held by the central government, 15 percent by the concerned state government and 35 percent by the sponsoring bank.

- **Cooperative Banks:** With the passage of Cooperative Credit Societies Act, 1904, the Indian banking sector has witnessed the emergence of another set of banks i.e. the cooperative banks. The objective of the cooperative banks is to facilitate rural credit and to promote the habit of savings and self- help among the farmers and economically weaker sections of the society. Like commercial banks, the co- operative banks also receive deposits and lend money. Co- operative banking in India can be divided into two important types on the basis of their functions. They are-

  (a) Agricultural Co- operative Banks: They are primarily operative at the village level, central co- operative banks at the district level and the state co- operative banks at the state level.

  (b) Non- agricultural Co- operative Banks: They mainly include Urban Co- operative Bank, Employee Credit Co- operative Banks and Housing Co- operative Banks.

- **Development Financial Institutions:** Development Financial Institutions or development banks are the **special financial institutions** that provide long- term financial assistance to the industry, agriculture and other important sectors of the economy. The functions of these banks are not only confined to providing finance but also include those services which are necessary in setting up new ventures as well as modernization and diversification of old ventures. These services include underwriting services, equipment finance, project guide, consultancy and advisory services to new and small entrepreneurs etc. Some of the national level development banks are the Industrial Finance Corporation of India

Limited (IFCI Ltd., 1948), the Industrial Development Bank of India (IDBI, 1964), the Small Industries Development Bank of India (SIDBI, 1990) etc. These development banks are also established at the state level. These are known as State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), State Small Industries Development Corporations (SSIDCs) etc. to meet the needs of the industries of the respective states.



CHECK YOUR PROGRESS

Q2: State whether the following statements are true or false:

a.State Bank of India is the central bank of India.

b. Cooperative banks are established by private businessmen.

c. Development financial institutions provide long- term funds to industries.

d. Reserve bank of India is a private sector bank.

14.6 ROLE OF COMMERCIAL BANKS IN ECONOMIC DEVELOPMENT

In this section we are going to discuss the role played by commercial banks in the economic development of a country. The commercial banks deal in money and credit and also help in the growth of the economy. More specifically, the role of the commercial banks can be discussed under the following heads-

- **Capital formation:** Commercial banks play an important role in the formation of capital. They mobilise the savings of people through various accounts- Fixed, Current and Savings accounts etc. and invest the money in various productive investments. It accelerates the rate of investments in the country which lead to the economic growth of the country.
- **Effective implementation of monetary policy:** The effective implementataion of ***monetary policy*** is not possible without the

copoperation of commercial banks. The commercial banks provide the mechanism to expand or control the supply of money in the economy. Therefore, commercial banks are essential to face the inflation and deflation in the economy.

- **Promoting trade and industry:** The banks are an important means in the industrial development of a country. The industries need long- term finance for investments in fixed assets, like purchasing of machineries, land and building etc. At the same time they also need short- term funds also to meet their working capital needs, like purchasing of raw- materials etc. The banks are the institutions which help the industries in meeting their different financial needs.
- **Promoting agricultural sector:** The activities of commercial banks are not only confined to providing finance to big industries. The banks also participate in the development of agricultural and rural sectors. They provide financial assistance to the farmers, artisans, small-scale industries in the rural areas. Regional Rural Banks are the best examples of commercial banks' initiatives for rural development.
- **Intermediation:** Banks, because of their reach, and the trust of the people in them have emerged as the biggest intermediaries across the world. Banks provide the platform to meet the needs of those having surplus money and those who are in the need of money. This leads to productive investment, employment generation and economic welfare of the society. Thus, banks, as the largest financial intermediaries, have a crucial role to play in the growth of businesses, industries, regions and the economy at large.



ACTIVITY

"Commercial banks are essential in the economic development of a country". Give comments.

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14.7 EMERGING SERVICES IN INDIAN BANKING

In recent years commercial banks have introduced various modern services for the benefit of its customers. Besides the traditional functions of accepting deposits and providing credit facilities, they have moved a step further by engaging themselves in investment functions i.e. investment in different securities on behalf of customers. In this section we will discuss some of the emerging services of modern commercial banks-

1. **Portfolio Management:** Probably you are aware that in stock exchanges investors can buy and sell different securities with the help of brokers. But the lack of skill, information and time makes it difficult for individual investors to choose the most profitable investment avenues. Thus, banks have come forward to provide advisory and fund management services to take care of the customers' funds. Banks provide portfolio management service against a fee. Thus, 'Portfolio management' is concerned with the **management of securities and assets** that meet the needs of the investors. Generally, the banks and other financial institutions manage the shares, debentures and real estates of their clients. The clients may be institutions or individuals.

   The bank on behalf of the clients manages their investments. However, the risk involved in investment is always borne by the investor, not by the bank. The bank through professional skill and expertise manage the investors' money to give them the best mix of securities. The bank tries to meet the objective of the investors in terms of risk, return, growth, safety etc. Portfolio management provides the individual investment solutions to the clients.

2. **Mutual Fund:** The commercial banks are providing an important service to investors through mutual funds. A mutual fund company is an ***investment company*** which collects money from varied investors and invests the money in stocks, shares, bonds etc.

Money generated by the mutual fund institution is managed by an efficient **fund manager**. The mutual fund companies are the subsidiaries of banking and insurance companies, which are formed under Companies Act, 1956. Their functions are controlled by Securities and Exchange Board of India (SEBI).The mutual fund companies are also emerging in private sector. The mutual funds invest the money in diversified securities to maximize the return and minimize the risk for the investors. The investors are called **unit holders** and their investment is calculated in terms of number of units purchased by them. The return from investment is paid back to the unit holders in proportion to the units held by them.

In India, the Unit Trust of India was the first institution to popularize the concept of mutual fund. Let us see the process of mutual fund as shown in the figure below:

1. **Factoring:** Another important service provided by the banks to the business organizations is the factoring service. We are aware that business organizations makes their purchase and sale transactions both in cash and on credit. In case of cash transactions, there is not much difficulty as cash is immediately received or paid. But in case of credit transactions, the seller (creditor) has to wait till the expiry of credit term to receive the payment from the customer (debtor). The main problem in this case is that even in case of urgency, the seller will not be able to get the money before the expiry of the credit term. In this respect, the factoring service can play an important role to relieve the seller so far as his financial emergency is concerned.

   Factoring is the arrangement with a financial institution whereby the financial institution purchases the ***accounts receivables*** of the business organization (seller). Thus, the credit sales are immediately converted into cash as the financial institution makes prepayment of around 80% of the accounts receivables to the business

organization. The balance 20% is paid after the customer makes the payment of the invoice. The financial institution is known as **factor** and the seller is known as **client**. The factor arranges the collection of debts and administers the sales ledger. In turn, the factor charges his fees, known as **factoring charges**. In case the debtor fails to make payment on due date, the factor recovers the amount from the client. The mechanism and the relationship among the factor, client and the customer can be shown as under-



CHECK YOUR PROGRESS

Q3: Select the correct answer-

a. Portfolio management is concerned with-

(i) investment in shares (ii) issuing of credit cards

(iii) providing loans to customers (iv) issuing letter of credit

b. The investors in mutual funds are known as-

(i) Fund manager (ii) Unit holders

(iii) Customers (iv) Client

c. In factoring arrangement, the factor is the –

(i) Financial institution (ii) Customer

(iii) Seller (iv) none of the above

14.8 LET US SUM UP

In this unit we have discussed the following aspects-

- Commercial banks are the financial institutions which deal in money.
- The main functions of commercial banks are-
  - to accept deposits from public;
  - to provide loans and advances to the business firms and individuals;
  - creation of credit; and
  - providing agency and general utility services.

- The main deposit schemes of banks are-
  - Fixed Deposit Accounts;
  - Current Deposit Accounts;
  - Savings Deposit Accounts; and
  - Recurring Deposit Accounts.
- Commercial banks provide financial help in the form of-
  - Loans;
  - Overdraft;
  - Cash Credit; and
  - Discounting of Bills of exchange.
- Reserve Bank of India is owned by the Government of India and it exercises control over monetary policy and commercial banks.
- Scheduled commercial banks can be classified as –
  - Public sector banks;
  - Private sector banks; and
  - Foreign banks.
- The commercial banks play an important role in the economic development of a country by encouraging capital formation, promoting trade, industry and agriculture, implementing the monetary policy etc.
- Indian commercial banks are providing modern services to individual customers as well as the business firms, such as, portfolio management, mutual fund, factoring services etc.



14.9 FURTHER READING

- Pathak V. Bharati (2008). T*he Indian financial system: Markets, institutions and services (2nd Ed.).* New Delhi, Pearson Education.
- Khubchandani B.S. (2007). *Practice and law of banking.* New Delhi, Macmillan India Ltd.

- Natarajan S. & Parameswaran R. (2006). *Indian banking.* New Delhi, S. chand & Co. Ltd.
- Paul R.R. (2007). *Money banking & international trade.* , New Delhi, Kalyani Publishers



14.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1:a. False b. True c. False d. False e. False

Ans to Q2:a. False b. False c. True d. False

Ans to Q3: a. i b. ii c. i



14.11 MODEL QUESTIONS

1. Define commercial banks.
2. Discuss the primary functions of commercial banks.
3. Discuss the agency services provided by commercial banks.
4. What do you mean by portfolio management?
5. Write short notes-
   - i. Factoring service.
   - ii. Cash credit.
   - iii. Discounting of bills
   - iv. Scheduled commercial banks.
   - v. Credit creation.

UNIT 15: MUTUAL FUND

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning of Mutual Fund

15.4 Constitution and Management of Mutual Fund

15.5 Buy Back of securities

15.6 Conditions for Buy-Back of Securities

15.7 Mode of Buy Back of Securities

15.8 Let Us Sum Up

15.9 Further Reading

15.10 Answers To Check Your Progress

15.11 Model Questions

15.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- discuss the meaning of mutual fund
- explain the risk involvement with mutual fund
- discuss the buy back of securities
- explain the objectives and conditions of buy back of securities
- discuss the Mode of buy back of securities.

15.2 INTRODUCTION

In this unit we are going to discuss about mutual fund. The mutual fund is nothing but a collective investment vehicle. It pools the resources invested in securities and distribute the returns among them on cooperative principles. The mutual funds have emerged as one of the important classes of financial intermediaries which cater to the needs of retail investors. It is a fund established in the form of a trust to raise monies through the sales of units to the public or a section of public under one or more schemes for investing in securities including money

market instruments or gold or gold related instruments. This unit deals with the concept of mutual fund and the risk associated with it. In this unit, we are going to discuss the buy back of securities, its objectives and different conditions related to it. The unit also takes into account the mode of buy back of securities. Thus, you will able to understand through this unit the meaning, objectives, different conditions, and mode of mutual fund and the risk associated with it.

15.3 MEANING OF MUTUAL FUND

The mutual fund is a special types of investment institution which pools the resources of small investors and deploys the same in the capital market instruments such as shares, debentures and other securities. It is a collective investment vehicle, formed with the specific objective of raising money from a large number of individuals. The profit or losses are shared by the investors in proportion to their investments. A mutual fund is set up in the form of a trust. It has sponsor, trustees, asset management company (AMC) and custodian.

The main advantages of investing in mutual fund are:

1. Professional management: The investor can avail the service from dedicated investment research team. They analyze the performance of the companies and select the suitable investment to the investor.
2. Diversification: Diversification reduces the risk. The mutual fund helps in investing in a number of companies across a broad cross-section of industries and sectors.
3. Convenient and economic Administration: It reduces many problems like less paper work, delay payments, bad delivery etc.
4. Return Potential: It provides higher return as mutual fund invests in diversified securities.
5. Low costs: Mutual fund is relatively less expensive as it directly invests and does not require paying brokerage and other fees.
6. Transparency: The investment in mutual fund is more transparent

as the investor can get regular information on the value of their investment, the proportion of investment in each class of assets etc.

The mutual fund may face the following risks:

1. The fund manager may not be accountable for poor result.
2. The planning of investment gives result of minimum return.
3. The different risks associated with the scheme may not be clearly identified.
4. Excessive diversification of portfolio, losing focus on the securities of the key segments.
5. Portfolio resulting in large payments of brokerage and commission, due to the necessity of higher turnover through liquidation.



CHECK YOUR PROGRESS

Q.1 Mention three main advantages of investing in mutual fund?

i. .....

ii. .....

iii. .....

15.4 CONSTITUTION AND MANAGEMENT OF MUTUAL FUND

Mutual funds are regulated by SEBI (Securities Exchange Board of India) (Mutual Fund) Regulations, 1996. Some of the important definitions in this regulation are given below:

Unit Holders: It means a person holding one or more units in a scheme of a mutual fund.

Unit: One undivided share in the assets of a scheme.

Trustees: Trustees means the Board of Trustees or the Trustee

Company who hold the property of the mutual fund in trust for the benefit of the unit holders.

Sponsor: Sponsor means any person who, acting alone or in combination with another body corporate, establishes a mutual fund.

Asset Management Company (AMC): AMC is a company registered and formed under the Companies Act, 1956. Under the regulation of SEBI every mutual fund company must have an Asset Management Company to manage the funds of the mutual fund. The AMC should have to enter into an agreement with the trustees to formulate the scheme. It raises the money against units, invests the funds and after meeting the permissible costs as per norms, distributes the income to the shareholders of the funds.

Custodian: Custodian means a person who has been granted a certificate of registration to carry on the business of custodian securities under SEBI (Custodian of Securities) Regulations, 1996.

REGISTRATION OF MUTUAL FUND:

Regulation 7 of SEBI lays down the criteria to get a certificate of registration. The criteria are:

a. The sponsor should have sound track record i.e. he is carrying financial services for a period of not less than five years and the net worth is positive in all the immediately preceding five years. The sponsor has profits after providing for depreciation, interest and tax.

b. If it is the case of existing mutual fund, it should be in the form of trust and the trust deed should have been approved by SEBI.

c. The sponsor has contribution of at least 40% to the networth of the asset management company.

d. The sponsor should not be found guilty of any fraud.

e. The appointment of the trustees and the Asset Management Company is made to manage the mutual fund.

f. Appointment of the custodian is made in order to keep custody of the securities or gold or gold related instruments and carry out the custodian activities as authorized by the trustees.

CONTENTS OF THE TRUST DEED:

A mutual fund is constituted in the form of a trust and the instrument of trust shall be in the form of a deed duly registered under Indian Registration Act, 1908. The Third Schedule prescribing the contents of the Trust Deed is as follows:

i) A trustee acting as a member of the Board of Trustee or trustee of the company shall maintain relationship with other companies or institutions or financial intermediaries or body corporate with which he may be engaged.

ii) The trustee cannot attend any meeting of the Board of Trustee or Trustee Company when any decision for investments in which he may be interested is taken.

iii) All trustees have to disclose their interest if they have in any company or institutions or financial intermediaries or body corporate by virtue of his position as director , partner or in any other capacity to the Board of Trustee or trustee of the company.

iv) The Trust Deed should provide that it can take custody of and control all property of the schemes of mutual fund and hold such property in trust of the unit holders.

v) The Trust Deed must contain the minimum number of trustees and the duty of trustees.

vi) The appointment of the Custodian is necessary he is appointed by the trustees and he is responsible for the supervision of the activities in relation to the mutual fund.

vii) The trustees can dismiss the AMC with the approval of the Board and it should be provided by the trust deed.

vii) The trust deed shall specify the *quorum* for a meeting of the trustees.

viii) The trust deed states that a meeting of the trustees shall be held at least once in every two months and at least six such meetings shall be held in every year.

ix) The removal of a trustee requires the approval of the Board.

x) The trust deed shall provide the responsibility of the trustees to supervise the collection of any income, for payment of tax, holding payment in trust for the holders in accordance with the Trust Deed.

CODE OF CONDUCT FOR MUTUAL FUND:

i. The mutual fund schemes should not be organized, operated, managed in the interest of the sponsors, directors of AMCs, members of Boards of Trustees.

ii. The trustees and AMC should provide to unit holders adequate and accurate information about the investment policies, financial policies of the companies etc.

iii. The trustees and AMC should ensure the schemewise bank accounts and security accounts.

iv. The trustees and AMC should provide the high standard service, exercise due diligence and ensure proper care.

v. The trustees shall furnish to SEBI on a yearly basis—

a. a report on the activities of the mutual fund,

b. a certificate to the effect that trustees, directors, key personnel of the AMC have not found any instances of self dealing etc.



CHECK YOUR PROGRESS

2. Mention three contents of trust deed?

i. .....

ii. .....

iii. .....

15.5 BUY BACK OF SECURITIES

'Buy-Back' means the purchase of its own shares or other specified securities by a company. It is a corporate financial strategy which involves capital restructuring and is prevalent globally with the underlying objectives of increasing earnings per share. It improves the return of the stakeholders. Buy Back of share is regulated by Securities and Exchange Board of India (Buy- Back of Securities) Regulations, 1998.

Companies take decision for buy-back of its own shares for the following *purposes*:

i. to achieve optimum capital structure
ii. to support the share price during the sluggish market conditions
iii. to return the surplus cash to the shareholders
iv. to improve the earning per share
v. to improve the return on capital
vi. to prevent unwelcomed takeover bids

According to section 77A (1), a company may buy-back of securities out of –

a. ***Free reserve and securities premium account:*** The investment allowance reserves, profit on re-issue of the forfeited shares, profits earned prior to incorporation of the company; revaluation reserves are not used for the purpose of buy-back. The debit balance if showed in the profit and loss account is first deducted from free reserve and then it is used for buy- back. The securities premium account can be utilized for buy-back of securities.

b. ***Proceeds of issue:*** The proceeds of an earlier issue of one kind of securities may be used in buy back of any other kind of securities. For example, the proceeds of an issue of preference can be used for buy back of equity shares.

c. ***Borrowings from banks or financial institutions:*** The borrowed money from the banks or any financial institution cannot be utilized for buy back of securities.



CHECK YOUR PROGRESS

Q3. Mention any three purposes for which companies take decision for the buy-back of its own shares?

i. .....

ii. .....

iii. .....

15.6 CONDITIONS FOR BUY-BACK OF SECURITIES

A company cannot buy-back its share if it is not authorized by the Article of Association. It may require permission from the Board and shareholders depending upon the quantum of buy-back.

a. ***Authority in the Articles:*** The buy-back of securities should be authorized by the Article of Association of the company. But, if it do not contain then, it should be amended.

b. ***Board resolution and quantum of buy-back:*** The Board can authorize the buy-back of securities not exceeding 10% of the total paid-up equity capital and free reserves of the company by passing a resolution.

c. ***Shareholders' resolution and quantum of buy-back:*** The Shareholders can authorize the buy-back of securities not exceeding 25% of the total paid-up equity capital and free reserves of the company by passing a special resolution.

d. ***Maximum quantum of buy-back:*** A company cannot buy-back more than 25% of its total paid-up capital and free reserves.

e. ***Further offer of buy back:*** Once buy-back has been made without the authorization of the shareholders but with the authorization of the Board, no further offer can be made without passing the special resolution and consent of the shareholders within 365 days from the date of the offer.

f. ***Fully paid-up securities qualify for buy-back:*** Under section 77A (2) (e), fully paid-up securities qualify for buy-back. If payment of calls or any sum remains due on the securities, it would not disentitle the company from buy-back. If the security has been issued at a discount, the payment of the total amount due thereon is sufficient for its buy back.



CHECK YOUR PROGRESS

Q4. Mention three conditions for buy-back of securities.

i. .....

ii. .....

iii. .....

15.7 MODE OF BUY BACK OF SECURITIES

Buy-back of securities may be made:

a) by purchasing securities which had been issued to employees of the company pursuant to a scheme of stock option or sweat equity.

b) from the existing securityholders on a proportionate basis, or

c) from odd lots

d) form the open market.

A listed company may buy-back its securities by any one of the following methods:

a) from the existing securityholders on a proportionate basis through tender offer

b) from the open market through:

i. book-building process ii. stock exchange

c) from odd-lot holders

A. ***Buy-back through tender offer:*** A listed company may buy-back its securities through tender offer at a fixed price after passing the resolution of the Board or shareholders. If it is intended by the

promoters then the quantum of securities proposed to be tendered and the details holding for the last 6 months prior to the passing of the special resolution is necessary to disclose. A public notice has to be given in at least one English National daily, one Hindi National daily and a regional language daily newspaper within 2 days of passing of the resolution by the Board. Public announcement should be done in at least one English National daily, one Hindi National daily and a regional language daily newspaper containing all the material information specified in Schedule II of the Regulation. In terms of public announcement the Schedule II of the Regulation contains:

a) Price, total number and percentage of the total paid-up capital and free reserves proposed to be bought back.

b) authority for the offer of buy-back.

c) the specified date.

d) the proposed time table for opening of offer

e) the present capital structure and shareholding pattern

f) Collection and bidding center

g) maximum amount invested in the buy –back etc.

A draft letter of offer along with the fees prescribed in Schedule IV of the Regulation filed with SEBI. It contains:

i) the process of buy-back

ii) the necessity of buy-back

iii) brief information about the company

iv) the details statutory approvals obtained

v) details of escrow account etc.

The shares which are tendered in dematerialized form a “Special depository Account” has to open through the Registrars to the offer. Here the Registrar and the company jointly receive the shares

through the account. The Registrar verifies the electronic receipt of shares into the account. The accounts are closed after the completion of all formalities and as all the shares are transferred to the company or investors as applicable after the verification. Payment for buy- back of securities should be made within 7 days from the date of completion of verification.

The company opens an *escrow account* with a schedule commercial bank on or before the opening of the offer for the buy-back of securities as specified below:

a. Where the consideration payable for buy- back does not exceed Rs.100 crores, 25% of the consideration payable.

b. But if it increase Rs. 100 crores, 25% upto Rs.100 and 10% of the balance.

The company has to furnish a certificate to SEBI certifying the compliance of the Regulations.

B. Buy- back through stock exchange: The stock exchange having electronic trading facility can easily identify the list of company as purchaser of securities to be bought back. Public announcement has to be made and a copy of it should be submitted to the SEBI. The company and the merchant banker have to publish information about the bought-back of the securities through the stock exchange on a daily basis in the national daily on a fortnightly basis. It is done on the daily basis when an additional five percent of the buy-back has been completed.

The company has to buy all securities offered by the security holders at the price stipulated by the company without attaching any conditions and if any conditions are attached it is on the discretion in the hand of company to buy or reject. The price of the securities may not be uniform.

C. Buy- back through book-building process: The book-building

process should be conducted electronically linked transparent system and at least 30 bidding centres take part having at least one such computer link. The company should have to make public announcement which discloses the tender offer, detailed methodology, manner of acceptance, bidding centers. The company has to appoint merchant banker. The company also has to open an escrow account.

The price is decided on the basis of quotations received from the securityholders. The highest accepted price should be final. It should be paid to all holders whose securities have been accepted for buy-back. The shareholders may indicate the number of shares and the number of shares they would like to tender at the 'cut-off price' which is determined by the Board. The 'final buy-back price' is the price which will be applicable to all the shareholders whose bids have been accepted and if the price of the 'final buy-back price' exceeds than the total number of shares offered , the company has to take decision on the basis of consultation with the manager to the offer. The following has to be taken into consideration when the 'final buy-back price' is fixed:

1. The price below the 'final buy-back price' should be given priority.
2. Bids should be accepted on pro-rata basis.
3. The rejected application form which is in the physical form should be returned to the shareholders.
4. The shares that are held in the demat form and are not accepted should be returned to the beneficial owner's Depository Account.



CHECK YOUR PROGRESS

Q5. Mention any three methods of a listed company for buy-back its securities.

i. .....

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ii. .....

.....

iii. .....

.....



15.8 LET US SUM UP

In this unit, we have discussed the following:

- A mutual fund is set up in the form of a trust.
- Custodian means a person who has been granted a certificate of registration to carry on the business of custodian securities under SEBI (Custodian of Securities) Regulations, 1996.
- A mutual fund is constituted in the form of a trust and the instrument of trust shall be in the form of a deed duly registered under Indian Registration Act, 1908
- The Trust Deed should provide that it can take custody of and control all the property of the schemes of mutual fund and hold such property in trust of the unit holders.
- Buy- Back of shares are regulated by Securities and Exchange Board of India (Buy- Back of Securities) Regulations, 1998 in case of listed companies and Unlisted Public Limited Company (Buy- Back of Securities) Rules, 1999 and the Companies Act, 1956 in case of unlisted companies.

- The investment allowance reserve, profit on re-issue of forfeited shares, profits earned prior to incorporation of the company, revaluation reserve are not used for the purpose of buy-back.
- A listed company may buy-back its securities by any one of the following methods:
  a. from the existing security holders on a proportionate basis through tender offer
  b. from the open market through:
     i. book-building process
     ii. stock exchange
  c. from odd-lot holders



15.9 FURTHER READING

- R. R. Paul(2014);*Money Banking and International Trade;*Kalyani Publishers
- M Y Khan(2017); *Indian Financial System;* McGraw Hill Education; Tenth edition
- S. K Misra & V.P Puri(2018); *Indain Economy;* Bandla Publications; 2018 edition
- SEBI Manual, Taxman



15.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: Three main advantages of investing in mutual fund are:

i.) Professional management: The investor avail service from dedicated investment research team. They analyze the performance of the companies and select the suitable investment to the investor.

ii.) Diversification: Diversification reduces the risk. The mutual fund helps in investing a number of companies across a board cross-section of industries and sectors.

iii.) Convenient Administration: It reduces many problems like less paper work, delay payments, bad delivery etc.

Ans to Q2: Three contents of trust deed are:

i) A trustee act as a member of the Board of Trustee or trustee of the company shall maintain relationship with other companies or institutions or financial intermediaries or body corporate with which he may be engaged.

ii) The trustee cannot attend in any meeting of the Board of Trustee or Trustee Company when any decisions for investments in which he may be interested are taken.

iii) All trustees has to furnish if any interest in any company or institutions or financial intermediaries or body corporate by virtue of his position as director , partner or in any other capacity to the Board of Trustee or trustee of the company.

Ans to Q3: Three purposes that companies take decision for buy-back of its

own shares are:

i.) to achieve optimum capital structure

ii.) to support the share price during the sluggish market conditions

iii.) to return the surplus cash to the shareholders

Ans to Q4: Three conditions of buy back of securities are:

a. ***Authority in the Articles:*** The buy-back of securities should be authorized by the Article of Association of the company.

b. ***Board resolution and quantum of buy-back:*** The Board can authorize the buy-back of securities not exceeding 10% of the total paid-up equity capital and free reserves of the

company by passing a resolution.

c. ***Shareholders' resolution and quantum of buy-back***: The Shareholders can authorize the buy-back of securities not exceeding 25% of the total paid-up equity capital and free reserves of the company by passing a special resolution.

Ans to Q5: Any three methods of a listed company for buy-back its securities are:

i.) from the existing security holders on a proportionate basis through tender offer

ii.) from the open market through:

a. book-building process

b. stock exchange

iii.) from odd-lot holders



15.11 MODEL QUESTIONS

1. What do you mean by mutual fund? What are the advantages of investing in mutual funds?
2. Describe the Constitution and Management of Mutual Funds.
3. Briefly discuss the code of conduct to be followed by Mutual Funds.
4. What are the contents of the trust deed?
5. What do you mean by buy back of securities?
6. What are the conditions for buy-back of securities?
7. What are the different modes of buy back of securities?