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Theory and Practice of Banking

SEMESTER - VI

COMMERCE



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BECHELOR OF COMMERCE

THEORY AND PRACTICE OF BANKING

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COURSE INTRODUCTION

This course "**Theory and Practice of Banking**" has been structured to give the basic idea of banking practices in our country to the learners of B. Com. programme. This course contains 15 units. In the first part of the book, you will get an idea of Indian banking system. In the subsequent part you will get an idea about the operational practices of Indian banks like-banker customer relationship, operation of bank account, different types of bank customers, negotiable instruments, protection for collecting bankers, protection to paying bankers, bank advances, and security for advances. You will also get an idea about banking legislations of India in unit 10. Various credit control techniques and central banking functions are also discussed in unit 8 and 9. The credit creation process of commercial banks is discussed in unit-7. Keeping in view the recent technological influence on banking sector one unit on E-banking solution is also incorporated.

While going through a unit, you will notice that some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some ''ACTIVITY'' (s) has been included to help you to apply your own thoughts. Again, we have included some relevant concepts in ''LET US KNOW'' along with the text. At the end of sections, you will get ''CHECK YOUR PROGRESS'' questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ''ANSWERS TO CHECK YOUR PROGRESS'' given at the end of each unit.

UNIT 1: INTRODUCTION TO INDIAN BANKING SYSTEM

UNIT STRUCTURE

1.1 Learning Objectives
1.2 Introduction
1.3 Definition of Bank
1.4 Evolution of Banks
1.5 Nationalization of Banks
1.6 Present Scenario
1.7 Recent trends in Indian Banking Practices
1.8 Role of Banks
1.9 Let Us Sum Up
1.10 Further Reading
1.11 Answers to Check Your Progress
1.12 Model Questions

1.1 LEARNING OBJECTIVES

After studying this unit, you will be able to:

- understand the meaning of 'bank'
- explain the role of a bank
- review the evolution of banking in India
- identify the recent changes in Indian banking practices

1.2 INTRODUCTION

Banks play a constructive role in the economic development of a country. Banks are important because they can contribute towards economic growth and financial stability. In emerging economies, banks are very important for the role played by them. They take a lead role in developing financial markets, channelize the surplus money to those who need it for productive uses, provide a mechanism of payment and provide a wide range of financial services to the people. The activities of banks have changed

over the time and evolved with the needs of the economy. The transformation of the banking system has been brought many reforms in the forms of deregulation, technological innovation and globalization. In this unit we will discuss the evolution of banks in India.

1.3 DEFINITION OF BANKS

In the Indian context, the definition of the banking business has been given in the Banking Regulation Act, 1949.

According to Section 5(c) of the Banking Regulation Act, 'a banking company is a company which transacts the business of banking in India.'

Section 5(b) of the Act 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 cheque, draft, and order or otherwise.'

1.4 EVOLUTION OF BANKS

It is believed that banking had it origination even before 2000 BC in Babylonia where people use to keep their money and valuables for safe keeping. Banking business started as a safe keeper at initial days and gradually shifted other functions as fund transfer facility and letter of credit facilities. The first bank in institutional form rendering only banking services is believed to be the Bank of Venice (1157 AD), The bank of Barcelona and Bank of Geneva were established in 1401 and 1407 AD respectively. The modern banks have their roots in the 17th century like Bank of Austerdum in Holland (1609 AD),

Bank of Hamberg in Germany (1619 AD) and Bank of England in UK (1694 AD). Banking business in joint stock company format were initiated in the 18th century and become the base of modern banking system.

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the

Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank, a bankers' bank and a banker to the Government. The Imperial Bank of India was established with mainly European shareholders. It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end. In 1860, the concept of limited liability was introduced in Indian banking, resulting in the establishment of joint-stock banks. In 1865, the Allahabad Bank was established with purely Indian shareholders. Punjab National Bank came into being in 1895. Between 1906 and 1913, other banks like Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. After independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank taking over the Imperial Bank of India and integrating with it, the former state-owned and state-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries. To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalization of another six private banks in 1980. With the nationalization of these banks, the major segment of the banking sector came under the control of the Government. The nationalization of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilization, thereby giving boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases,

and banks getting burdened with large non-performing assets.

To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. Following this decision, new banks such as ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up.

Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions. Further, the share of long-term financing (in total bank financing) to meet capital goods and project-financing needs of industry has also increased over the years.

1.5 NATIONALIZATION OF BANKS

During the colonial era many Indian banks were founded either by the Princely States or by wealthy individuals. The primary aim of most of the banks was to cater financial needs of trade and industry in that locality. During this period the banking services became the privilege of big business firms and wealthy individuals. Masses were denied easy credit and banking services. Agriculture and rural small scale industries did not have access to credit facilities and banking services and were neglected. They depended on village money lenders and other private financiers to fund their activities and they were exploited by these local financial service providers by means of high interest rates, harsh repayment conditions and other unfair practices. All these paved the way for the nationalization of banks in India. Nationalization

of banks in India took place in phased manner. The RBI was taken over by the government in the year 1949. In 1955 the Imperial Bank of India became State Bank of India with an Act of parliament. Over time, eight banks of princely states were nationalized and made subsidiaries to the State Bank of India.

The nationalization of banks in true sense took place in the year 1969 which brought a revolution in the field of Indian Banking. It was different from nationalization of the Reserve Bank of India (RBI) in 1949 and nationalization of the Imperial Bank in 1955, as these were having very little socio-economic impact compared to the changes brought in 1969.

With the social welfare objective, fourteen leading commercial banks were nationalized on July 19, 1969. After a lapse of more than ten years of the first phase of nationalization of banks, on April 15, 1980, six more banks were nationalized in the second phase of nationalization. The list of these banks is given below. The New Bank of India was later merged with the Punjab National Bank in 1993. Following is the list of Nationalized Banks:-

1st Phase (1969)

1. Allahabad Bank
2. Bank of Baroda
3. Bank of India
4. Bank of Maharastra
5. Canara Bank
6. Central Bank of India
7. Dena Bank
8. Indian Bank
9. Indian Overseas Bank
10. Punjab National Bank
11. Syndicate Bank
12. Union Bank of India
13. United Bank of India
14. United Commercial Bank.

2nd Phase (1980)

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of India
5. Punjab and Sind Bank
6. Vijaya Bank

The nationalized banks in India adopted the social welfare concept and focused on rural and agricultural sectors as a part of their social responsibility. Their resources were utilized to empower farmers and agricultural laborers in order to free them from the clutches of money lenders. After this period the Public Sector banks expanded their reach and grew in leaps and bounds. The nationalized banks in India expanded their branches and spread their activities across the country. They introduced new schemes and programs to cater all sections of the society. Thus the nationalization of Banks in India helped the masses to avail banking services at affordable cost.

1.6 PRESENT SCENARIO

Various reforms have been introduced in Indian banking sector to improve the operational efficiency and upgrade the health and financial soundness of banks so that Indian banks can meet internationally accepted standards of performance. Initially banks were merged to save non-performing banks or non efficient banks but as time evolved the system too evolved. In the recent times mergers and acquisitions have also been made on grounds of business growth, profitability and organizational restructure.

During pre-nationalization period (1961-69) as many as 46 mergers took place mostly of private sector banks in order to revive the poorly performing banks which proved to be quite a successful move for the underperforming banks.

In post nationalization period (1969-91) six more private banks were nationalized (in 1980). In this period 13 mergers took place mostly between public and private sector banks.

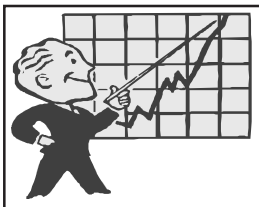
The post reform period (1991- till now) saw major economic reforms initiated by Government of India. During this period the Indian banking system witnessed many changes. Many mergers took place - some to save weaker banks and some for the sake of synergic business growth. The Oriental Bank of Commerce merged with Global Trust bank in 2004 .Mergers of Punjab National Bank (PNB) with the then eroded New Bank of India (NBI) in 1993-94 and that of Benaras State Bank Ltd with Bank of Baroda in 2002

also proved to be life saving for the weaker bank. In the year 2008 State Bank of Saurashtra was merged with State Bank of India. Two years later in 2010, State Bank of Indore was merged with SBI. Union Cabinet decided to merge all the remaining five associate banks of State Bank Group with State Bank of India in 2017. After the Parliament passed the merger bill, the subsidiary banks ceased to exist. Five associates and the Bharatiya Mahila Bank became the part of State Bank of India (SBI) beginning April 1, 2017. This has placed State Bank of India among the top 50 banks in the world. The five associate banks that were merged into State Bank of India were- State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Mysore (SBM), State Bank of Patiala (SBP) and State Bank of Travancore (SBT).

The government had merged Dena Bank and Vijaya Bank with Bank of Baroda in 2018. Oriental Bank of Commerce and United Bank merger with Punjab National Bank in 2019 which will give birth to India's second largest public sector bank after the State Bank of India (SBI). The government has also announced the merger of Canara Bank and Syndicate Bank. These two banks will be consolidated to form the fourth largest public-sector bank.

The biggest overhaul in public sector banks has left India with only 12 banks. The Regional Rural Banks also saw a massive change during post reform period. The numbers of RRBs has come down to 45 in 2019 from 196 in 2004.

At present(2019), in India, there are 12 public sector banks, 45 RRBs, 22 Private sector banks, 3 Local area banks, 10 Small finance banks, 7 Payment banks are operating. There are branches of 44 Foreign banks operating in India. Besides these there are 22 Scheduled State Co-operative Banks, 11 Non-Scheduled State Co-operative Banks, 54 Scheduled Urban Co-operative Banks, 1488 Non-Scheduled Urban Co-operative Banks, 33 State Co-operative Banks and 366 District Central Co operative banks in three tire co operative banking structure in India.



CHECK YOUR PROGRESS

Q 1: Define bank.

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Q 2: In which year the first phase of bank nationalization took place.

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1.7 RECENT TRENDS IN INDIAN BANKING PRACTICES

The Banking industry and financial institutions are vital sectors of any economy. Development of these two sections of the economy can impact the growth of the country in an incredible way. In the era of "Digital India", the banking and financial services in India have undergone a massive evolution and the phenomenon continues. Following are the some areas which has newly emerged in the recent past in Indian banking sector-

Debit card: Debit card is also known as plastic card, bank card. It is issued by the banks to those customers who have an account in their respective bank. Debit card is used instead of cash. Customer can purchase grocery items, payment of hotel bills, filling petrol etc through debit card. Debit card also used for withdraw or deposit the money. There are different types of cards like master card, maestro card , visa card etc. It is made of magnetic chip with 16 digit number .It is accepted more readily than cheque when we do the payment.

Credit card : Credit card are like debit card .The major difference is that in debit card the payment is paid through your account but in credit you can purchase the goods on credit and have to pay it after one month with interest/charge. It is also known as post paid card. Credit card is issued by the banks on the creditworthiness of the customer. The limit of credit is extended for valuable customers.

Smart card: Smart card is made of plastic with an imbedded integrated circuit that stores and process the information .In smart card the personal information, insurance information medical history all can be stored in it. The smart card to be inserted into a small card reader, which reads all the information stored on the card. In smart card special identification number is given.

SMS Banking: In SMS messages information relating to account are send to the customer by the bank. It is the choice of the customer to avail this facility or not. All the information relating to debit and credit of the account is sent to the customer on their registered mobile numbers.

Electronic Payment Services - E Cheques: Now a days we are hearing about e-governance, e-mail, e-commerce, e-tail etc. In the same manner, a new technology is being developed in US for introduction of e-cheque, which will eventually replace the conventional paper cheque. India, as harbinger to the introduction of e-cheque, the Negotiable Instruments Act has already been amended to include; Truncated cheque and E-cheque instruments.

Real Time Gross Settlement (RTGS) : Real Time Gross Settlement system, introduced in India since March 2004, is a system through which electronics instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by the RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial operations. As the name suggests funds transfer between banks takes place on a 'Real Time' basis. Therefore, money can reach the beneficiary instantaneously and the beneficiary's bank has the responsibility to credit the beneficiary's account within two hours.

Electronic Funds Transfer (EFT): Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/ company etc. can approach his bank and make cash payment or give instructions/authorization to transfer funds directly from his own account to the bank account of the receiver/beneficiary. Complete details such as the receiver's name, bank account number, account type (savings or current

account), bank name, city, branch name etc. should be furnished to the bank at the time of requesting for such transfers so that the amount reaches the beneficiaries' account correctly and faster. RBI is the service provider of EFT.

Electronic Clearing Service (ECS): Electronic Clearing Service is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfers by individuals.

Automatic Teller Machine (ATM): Automatic Teller Machine is the most popular devise in India, which enables the customers to withdraw their money 24 hours a day 7 days a week. It is a device that allows customer who has an ATM card to perform routine banking transactions without interacting with a human teller. In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry etc.

Core banking solution: Core banking is a service provided by banks to a group of bank branches through network where customers may access their bank and perform basic transaction from any of the member branch offices. It include, loans, transaction cost payment and mortgages. Bank provide these services through different channels like ATM, mobile banking and internet banking etc .The customer need not operate through his own branch but go to the nearest branch for services. He is not a customer of a branch but customer of bank.

Point of Sale Terminal: Point of Sale Terminal is a computer terminal that is linked online to the computerized customer information files in a bank and magnetically encoded plastic transaction card that identifies the customer to the computer. During a transaction, the customer's account is debited and the retailer's account is credited by the computer for the amount of purchase.

Tele Banking: Tele Banking facilitates the customer to do entire non-cash related banking on telephone. Under this devise Automatic Voice

Recorder is used for simpler queries and transactions. For complicated queries and transactions, manned phone terminals are used.



CHECK YOUR PROGRESS

Q 3: What is mean by ECS.

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Q 4: Write the full form of RTGS.

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1.8 ROLE OF BANKS

Commercial banks play three major roles. These are: (i) Financial Intermediary, (ii) Constituent of the Payment System and (iii) Financial Services Provider.

(i) Financial Intermediary: One of the important functions of a bank is financial intermediation that is to receive deposits from customers and then lend these funds to the borrowers. In financial terms, bank deposits represent the banks' liabilities, while loans disbursed, and investments made by banks are their assets. By making deposits in banks depositors enjoy interest, liquidity and safety. On the other hand loans and investments made by banks play an important role in channelizing funds into profitable as well as productive uses. The productive use may be of economic or social orientation. The deposits mobilized are usually lent for production in agriculture, industry and trade which create economic value. People belonging to lower income group and under developed region are benefited by getting financial support to start business and thus it creates not only economic benefits but also social benefits.

(ii) Constituent of Payment System: Banks are at the core of the payments system in an economy. A payment refers to the means by

which financial transactions are settled. Banks help in settling the financial transaction process is providing cheque facility to their customers through which they can issue cheque to others in lieu of cash payment. Banks also collect such cheques received by their customers. In modern banking, the payments system also involves electronic banking, electronic transfers, settlement of credit card transactions, etc.

(iii) Financial Services Provider: In addition to acting as financial intermediaries, banks today are increasingly involved with offering a wide variety of financial services to their customers. These services include investment banking services, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc. Income from providing such services improves a bank's profitability and helps in developing a sound financial system.



1.9 LET US SUM UP

In this unit we have discuss the following:

- Banks play a constructive role in the economic development of developed countries like India. Banks are important because they can contribute towards economic growth and financial stability.
- Section 5(b) of the Act 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 cheque, draft, order or otherwise.'
- The modern concept commercial bank came into India in 1786 with the establishment of the Bank of Bengal in Calcutta.
- The nationalization of banks in 1969 and 1980 adopted the social welfare concept and focused on rural and agricultural sectors as a part of their social responsibility. This resulted in remarkable growth and expansion in banking activities with special focus to unbanked areas.

- Commercial banks perform three major roles. These are: Financial Intermediary, Constituent of the Payment System and Financial Services Provider.



1.10 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.



1.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: 'According to Section 5(b) of the Banking Regulation Act,, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, and order or otherwise.'

Ans to Q No 2: 1969.

Ans to Q No 3: Electronic Clearing Service is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount.

Ans to Q No 4: Real Time Gross Settlement.



1.12 MODEL QUESTIONS

Q 1: What are the various roles played by a bank? Discuss.

Q 2: Describe the evolution of banking in India.

Q 3: Discuss the recent changes in Indian banking practices.

*** ***** ***

UNIT 2: BANKING SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Types of Banks

2.4 Classification on the Basis of Functions

- 2.4.1 Money Lenders and Indigenous Bankers
- 2.4.2 Commercial Banks
- 2.4.3 Investment Banks
- 2.4.4 Exchange Banks
- 2.4.5 Cooperative Banks
- 2.4.6 Central Banks

2.5 Classification on the Basis of the Second Schedule of the RBI Act

- 2.5.1 Scheduled Banks
- 2.5.2 Non-Scheduled Banks

2.6 Classification on the Basis of Domicile

- 2.6.1 Domestic Banks
- 2.6.2 Foreign Banks

2.7 Classification on the Basis of Ownership

- 2.7.1 Public Sector Banks
- 2.7.2 Private Sector Banks

2.8 Classification on the Basis of Organizational Structure

- 2.8.1 Unit Banking
- 2.8.2 Branch Banking
- 2.8.3 Group Banking
- 2.8.4 Chain Banking
- 2.8.5 Universal Banking

2.9 Let Us Sum Up

2.10 Further Reading

2.11 Answers to Check Your Progress

2.12 Model Questions

2.1 LEARNING OBJECTIVES

After studying this unit, you will be able to:

- know the meaning of indigenous bankers
- explain the meaning and functions of commercial banks
- know the meaning of domestic bank and foreign bank
- know the meaning of public sector bank and private sector bank.

2.2 INTRODUCTION

In the previous unit we discuss the basic concept of banks. There are various classifications of banks which operate in our country to meet the financial requirements of different categories of people engaged in agriculture, business, profession, etc. In this unit we will discuss different types of banks operating in India.

2.3 TYPES OF BANKS

The constituents of the present banking system in India are of varying origin and sizes. At the apex is the Reserve Bank of India, the central bank of the country which regulates the banking system in India. The banks in India can be classified into various categories on the basis of the following criteria.

a. Functions
b. Second schedule of the Reserve Bank of India Act
c. Domicile
d. Ownership
e. Organisation structure

2.4 CLASSIFICATION ON THE BASIS OF FUNCTIONS

On the basis of the functions performed by the banks, they may be classified into: (i) Money Lenders or Indigenous Banks, (ii) Commercial Banks, (iii) Investment Banks, (iv) Exchange Banks, (iv) Cooperative Banks, and (v) Central Banks.

2.4.1 Money Lenders and Indigenous Bankers

Before establishment of commercial banks, private money lenders and country bankers played an important role as sources of finance. These establishments were known as Indigenous Bankers. They used to charge a high rate of interest and exploited the people who took financial assistance. These banks have lost their monopoly with the development of commercial banks in India. Now-a-days even though a large number of commercial banks act in the banking system, the indigenous bankers have played a significant role because some people depend on indigenous bankers for financial assistance.

The indigenous bankers play a vital role in financing the internal trade. They are especially popular in the areas, which lack joint stock banks or are not properly served by these banks.

Functions of Indigenous Bankers. The main functions of the indigenous bankers are as follows:

- **Accepting Deposits:** The indigenous bankers accept deposits from the public. These deposits are of two types: (a) the deposits which are repayable on demand and (b) the deposits which are repayable after a fixed period. The indigenous bankers pay higher rate of interest than that of paid by the commercial banks.
- **Advancing Loans:** The indigenous bankers advance loans to their customers against all types of securities such as land, crops, gold and silver, etc. They also give credit against personal security. They provide loans to small industrialists who cannot fulfill the necessary loan conditions of commercial banks.
- **Business in Hundies:** The indigenous bankers deal in hundies. They write hundies, buy, and sell hundies. They also discount hundies and, thereby, meet the financial needs of the internal traders. They also transfer funds from one place to another through discounting of hundies.

- **Non-Banking Functions:** Most of the indigenous bankers also carry on their non-banking business along with the banking activities, they generally have their retail trading business, and sometimes, they act as agents to large commercial firms and earn income in the form of commission. They also participate in speculative activities.

Defects of Indigenous Banks: The indigenous bankers were suffering from many defects for which they could not continue successfully in the banking business. These defects are-

(a) Indigenous banks were engaged in other trading activities resulting in diversion of deposits to their own business houses which are very risky.

(b) Indigenous bankers usually suffer with low capital base.

(c) They were not maintaining books of accounts properly.

(d) Indigenous banks were suffering from lack of skilled manpower. Most of the personnel were not professionals.

(e) Indigenous bankers were not following the risk management measures in maintaining the credit portfolio and this was amounting to high risk.

(f) Most of these banks were indulging in unfair practices such as high interest charge, financing to trading activities and neglecting developmental activities, unethical practices in collection of debts etc.

2.4.2 Commercial Banks

Commercial banks pool the savings of the household who have surplus (savings) and lends the money to the various users in the form of loans. Thus, they receive deposits which are repayable on demand or on short notice. Banks usually finance the short term needs of trade and industry. They provide a number of financial services in addition to the main business of receiving deposits and lending money. Their functions have been changing to meet the demands of the modern days.

Functions of a Commercial Bank: The functions of commercial banks can be classified into two broad categories viz., primary and secondary. The primary functions refer to the basic functions performed by banks and includes acceptance of deposits, advancement of loan and investments and extending the payment mechanism to their customers. The secondary functions include various agency and utility services.

Primary Functions: Primary function of commercial banks includes acceptance of deposits, lending money and making investments, and providing payment mechanism.

1. **Accepting Deposits:** It is the most important function of commercial banks. They accept deposits in several forms according to requirements of different sections of the society. The main kinds of deposits are fixed deposits, current deposits and savings deposits.
   a. **Fixed Deposits or Time Deposits:** Fixed deposits refer to those deposits in which the amount is deposited with the bank for a fixed period of time. Such deposits do not enjoy cheque facility. These deposits carry a high rate of interest.
   b. **Current Account Deposits or Demand Deposits:** These deposits refer to those deposits which are repayable by the banks on demand. Such deposits are generally maintained by businessmen with the intention of making transactions with such deposits. They can be drawn upon by a cheque without any restriction. Banks usually do not pay any interest on these accounts; rather banks impose service charges for running these accounts.
   c. **Saving Deposits:** These deposits combine features of both current account and fixed deposit account. The depositors are given cheque facility to withdraw money from their account. But, some restrictions are imposed

on number and amount of withdrawals in order to discourage frequent use of saving deposits. They carry a rate of interest which is less than interest rate on fixed deposits. It must be noted that Current Account deposits and saving deposits are chequable deposits, whereas, fixed deposit is a non-chequable deposit.

2. **Advancing of Loans:** The deposits received by banks are not allowed to remain idle. So, after keeping certain cash reserves, the balance is given to needy borrowers and interest is charged from them, which is the main source of income for these banks. Different types of loans and advances made by Commercial banks are:

   a. **Cash Credit:** Cash credit refers to a loan given to the borrower against his current assets like shares, stocks, bonds, etc. A credit limit is sanctioned and the amount is credited in his account. The borrower may withdraw any amount within his credit limit and interest is charged on the amount actually withdrawn.

   b. **Demand Loans:** Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the account and interest is payable on the entire sum.

   c. **Short-term Loans:** They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire sum of loan granted.

   d. **Overdraft Facility:** It refers to a facility in which a customer is allowed to overdraw his current account up to an agreed limit. This facility is generally given to respectable and reliable customers for a short period. Customers have to pay interest to the bank on the amount overdrawn by them.

e. **Discounting Bills of Exchange:** It refers to a facility in which holder of a bill of exchange can get the bill discounted with bank before the maturity. After deducting the commission, bank pays the balance to the holder. On maturity, bank gets its payment from the party which had accepted the bill.

3. **Investments:** The objective of borrowing or receiving deposits is to lend or make investments so that banks can get income. Out of this income banks are supposed to pay interest to the depositors in addition to cover the operational cost. Banks invest a part of mobilized deposits in various form of securities to earn income.

Secondary Functions: The secondary functions of banks include various agency and utility services. These are discussed below.

Agency Functions: Commercial banks also perform certain agency functions for their customers. For these services, banks charge some commission from their clients. Some of the agency functions are:

(i) **Transfer of Funds:** Banks provide the facility of economical and easy remittance of funds from place-to-place with the help of instruments like demand drafts, mail transfers, Electronic Money Transfer (EFT), etc.

(ii) **Collection and Payment of Various Items:** Commercial banks collect cheques, bills, interest, dividends, subscriptions, rents and other periodical receipts on behalf of their customers and also make payments of taxes, insurance premium, etc. on standing instructions of their clients.

(iii) **Purchase and Sale of Foreign Exchange:** Some commercial banks are authorized by the central bank to deal in foreign exchange. They buy and sell foreign exchange on behalf of their customers and help in promoting international trade.

(iv) **Purchase and Sale of Securities:** Commercial banks buy and sell stocks and shares of private companies as well as government securities on behalf of their customers.

(v) **Income Tax Consultancy:** They also give advice to their customers on matters relating to income tax and even prepare their income tax returns.

(vi) **Trustee and Executor:** Commercial banks preserve the wills of their customers as trustees and execute them after their death as executors.

(vii) **Letters of Reference:** They give information about the economic position of their customers to traders and provide the similar information about other traders to their customers.

General Utility Functions: Commercial banks render some general utility services like locker facility, money transfer, traveler's cheque, letters of credit, underwriting, etc.

2.4.3 Investment Banks

Investment banks supply fund for the long term needs of industries. They raise their fund through share capital, debenture and loans, and long term deposits from the public. They do not receive public deposits like commercial banks which are withdrwable on demand. In India, investment banks are also known as development banks. Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) were originally development banks and converted into commercial banks and known as ICICI Bank and IDBI bank respectively at present. Their objective is to look into the developmental needs of the country and people.

2.4.4 Exchange Banks

International trade has a great role today in the economy of each and every nation. To meet the needs of international trade with regard to exchange facilities, short term finance and guarantees,

specialized banks are there to take care. These are known as Exchange banks or EXIM Banks. In many cases, commercial banks also undertake the business of exchange banks.

2.4.5 Cooperative Banks

Cooperative banks undertake banking business but these are formed on the principle of cooperation and registered under the Cooperative Society Act. The short term needs of agriculturists and artisans who form such cooperative banks get their short term financial requirements from these banks. In India, cooperative banks have a three tier structure. At the top there is State Cooperative Bank at the state level, and governs all the cooperative banks in the state. At district level, there are central cooperative banks and act as the intermediaries between state cooperative banks and primary cooperative banks. At the bottom level, primary Cooperative Banks act as financier to the real beneficiaries such as farmers and artisans.

2.4.6 Central Banks

Central bank is the apex bank of the banks in a country. It is the bank that controls and governs the banking system in the country. The central bank is also the banker of the government and acts as catalyst to the development and growth of the nation. It occupies an important place in monetary and banking system and maintains economic stability through different measure like credit control. The Reserve Bank of India is the central bank of India. Similarly, Federal Reserve Bank and Bank of England are the central banks of the USA and UK respectively.

2.5 CLASSIFICATION ON THE BASIS OF THE SECOND SCHEDULE OF THE RBI ACT

Banks in India can be classified in to Scheduled or Non-Scheduled Banks on the basis of the second schedule of the RBI Act 1934.

2.5.1 Scheduled Banks

A scheduled bank is one, which is registered, in the second schedule of the Reserve Bank of India. The following conditions must be fulfilled by a commercial bank for inclusion in the schedule.

- The banker concerned must be in business of banking in India;
- It is either a company defined in Section 3 of the Indian Companies Act 1956, or corporation or a company incorporated by or under any law in-force in any place outside India or an institution notified by the Central Government in this behalf;
- It must have paid-up capital and reserves of an aggregate real exchangeable value of not less than rupees five lakhs;
- It must satisfy the Reserve Bank of India that its affairs are not conducted in a manner detrimental to the interests of its depositors.

Schedule banks are under the purview of the various credit control measures of the RBI. They are required to maintain a certain minimum balance in their accounts with RBI and do certain things prescribed by the RBI. They also enjoy certain privileges from the RBI such as refinancing facilities, clearance facilities etc.

2.5.2 Non-Scheduled Banks

Banks that are not included in the second schedule of the RBI are known as non-scheduled banks. They may be classified into four groups:

1. Banks with paid-up capital and reserves in excess of Rs. 5 lakhs.
2. Banks with paid-up capital and reserves ranging between Rs. 50,000 and one lakh rupees.
3. Banks with paid-up capital and reserves ranging between one lakh of rupees and five lakhs.

4. Banks with paid-up capital and reserves below Rs. 50,000.

Non-scheduled banks are not entitled to all the facilities that the scheduled banks avail from the RBI. These types of banks do not exist in India at the present.

2.6 CLASSIFICATION ON THE BASIS OF DOMICILE

On this basis of the origin of the country, banks can be classified into (i) domestic banks or (ii) foreign banks.

2.6.1 Domestic Banks

These are the banks which are registered or incorporated in India. These banks are formed and governed as per the Indian Laws. All the public sector banks and Indian private sector banks registered under Indian Laws in our country are domestic banks.

2.6.2 Foreign Banks

Foreign banks are registered or incorporated outside India as per the law of a foreign country but operating in India through its branches. Foreign banks also undertake usual banking business in addition to foreign exchange transactions. Foreign scheduled commercial banks are regarded under the second schedule of RBI but have their registered offices outside India. These banks have played a prominent role in India's foreign trade until the Second World War. Since then, a number of leading Indian banks also entered into the field of international trade. Similarly, foreign banks have also entered in the field of internal trade and started competing with Indian commercial banks in attracting deposits, discounting bills and making advances to trade and industry. There were 29 foreign banks with 279 branches in India as on March 2008.

2.7 CLASSIFICATION ON THE BASIS OF OWNERSHIP

On the basis of ownership pattern, Indian commercial banks may be classified as (i) Public Sector Banks or (ii) Private Sector Banks.

2.7.1 Public Sector Banks

A Public Sector bank is one in which, the Government of India holds a majority stake.

It is as good as the government running the bank. Since the public decide on who runs the government, these banks that are fully/partially owned by the government are called public sector banks.

The public sector banks include State Bank of India, its five subsidiaries and twenty nationalized banks. Thus, there are 26 public sector banks at present. State Bank of India is the biggest commercial bank in the country. It was originally established in 1806 when the Bank of Calcutta (latter called Bank of Bengal) was established, and then amalgamated as the imperial bank of India after merger with the Bank of Madras and the Bank of Bombay. The share of Imperial

Bank was sold to the Reserve Bank of India and thus it came into existence on July 1, 1955 under the State Bank of India Act 1955. The State Bank of India has played an important role in extending credit facilities to cooperative undertakings, self-employed professionals, and small-scale and cottage industries. The central government nationalized other state banks functioning in different states and made them subsidiaries of the State Bank of India. Initially, State Bank of India had eight subsidiaries. After merger of some of the banks, now the State Bank of India has only five subsidiaries viz. State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore.

In the first phase of nationalization, 14 private sector banks were nationalized in the year 1969 and in the second phase 8 more private sector banks were nationalized by the Central Government. Later, Punjab National Bank was merged with the New Bank of India

in the year 1993. The IDBI Bank got the status of a commercial bank in the year 2004 and categorized as Other Public Sector Bank by the RBI. At present (2019), in India, there are 12 public sector banks

2.7.2 Private Sector Banks

Whereas Private Sector Banks are those Banks where the management is controlled by Private individuals and Government does not have any say in the management of these banks. Maximizing profit is the basic motto of private sector banks.

The private sector banks include both scheduled commercial banks and non-scheduled commercial banks. These banks perform the same functions as performed by other commercial banks and follow the regulations framed by the RBI. Private sector banks are further classified into old private sector banks and new private sector banks that emerged after 1991. As per RBI, at present there are 22 Private sector banks operating in India. These banks have a network of 8,294 branches that accounts for 10.5 percent of the total.



CHECK YOUR PROGRESS

Q1: Define domestic bank.

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Q2: Define private sector bank.

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2.8 CLASSIFICATION ON THE BASIS OF ORGANIZATIONAL STRUCTURE

Banking system may be classified on the basis of organization structure into unit banking, group banking, chain banking, branch banking or universal banking.

2.8.1 Unit Banking

In Unit banking system banks operations are restricted to a limited area. Unit banking is dependent on its localized customer base. In Unit banking there is high "Convenience Cost" for residents of the area. Unit bank has to raise and utilize its capital, deposits locally. Under unit banking the number of banking offices that a town can support is a function of minimum of deposits, loans where as under branch banking it is a function of the sum. Local area banks and Regional Rural banks in India are the replica of unit banking.

Advantages: Due to limited and restricted area of operations, unit-banking system enjoys certain inherent advantages. These are:

1. In unit banking, a bank is well versed with local conditions, local needs etc. Being well versed with the economic problems, financial requirements of the masses and of business community, bank is able in designing and marketing financial products to suit the needs of all segments.
2. Bank develops an image of friendly and caring bank, which ultimately helps in developing business and customers' loyalty. This enables bank in building long lasting relationship with customers.
3. The operating cost of unit bank is much lower than the banks following branch-banking system.
4. The employees of a unit bank are like a close-knit society, which helps in building mutual trust and confidence. This creates congenial environment at the work place and enhances employees' productivity.
5. Bank is able to have direct supervision and control over its operations, thus reducing if not eliminating the chances of losses due to frauds, forgeries etc.

Disadvantages: Units banks have the following disadvantages.

1. Limited area of operations exposes various types of risks to the business.

2. The service range provided to the customer is also limited which reduces the service quality.
3. Business depends on the economic conditions and business prospects of the area.

2.8.2 Branch Banking

As per Banking Regulations Act 1949 "branch" or "branch office", in relation to a banking company, means any branch or branch office, whether called pay office or sub pay office or by any other name, at which deposits are received, cheques cashed, or moneys lent and for the purposes of Sec. 35 includes any place of business where any other form of business referred to in subsection (1) of Sec 6 is transacted. Thus a branch is an office where banking transaction viz. accepting of money for the purposes of lending or investment and any or all the banking services are carried out. Branch banking is multi-office banking spread over to a vast geographical area.

Advantages: -

Branch banking has the following advantages over unit banking system.

1. **Large scale operations:** Branch banking enjoys the benefits of large scale operations. It has the large capital base, manpower and geographical coverage and all these contribute to economy in cost as well as increase in efficiency.
2. **Broad Customer Base:** Since, there are no geographical bindings on doing business, it has broader customer base. This helps them to expand their business and be more innovative.
3. **Deposit Mobilization:** There are no constraints in mobilization of recourses and their utilization because of wide geographical coverage. This helps to garner large financial resources for the banking business.

4. **Better Credit Management:** In branch banking banks can make proper deployment of resources. There are places where a branch receives more deposits than it makes advances. Deposits received by one branch can be profitably used as loans or investments by another branch. Unless the supply and demand for capital is exactly the same across locations, branches will specialize to some degree in either collection of deposits or disbursement of loans and advances.
5. **Spread of Risk:** Business risk is well spread over a large area. This helps in diversification of risk and thus reduces the total risk. Losses arising in an area are taken care by the earnings in other area, which neutralize risk, and bank is protected from setbacks. It also reduces risk inherent to a given type of asset through diversification, and helps banks in adjusting their assets and liability.
6. **Healthy Business Environment:** A branch banking system may be able to support more banking offices in a particular location and thus the extent of local monopoly power is likely to be lower. This creates a healthy business environment.
7. **Qualitative Service:** Because of large bank network, skilled manpower and access to larger financial resources banks are in a position to develop new product and enhance the service quality.

Disadvantages

The branch banking system is not free from limitations. These are:

1. **High Cost of Branches:** Though, branch banking enjoys benefits of large scale operation, it also suffers from high cost due to unviable branches. All the branches opened may not have same volume of business and cost. Some of the branches may have low volume of business but high operational cost and this may lead to high operational cost.
2. **Problems of Supervision:** Since the branches are spread over vast geographical area, effectiveness and efficacy of

supervision and control mechanism gets diluted which exposes the bank to various types of risks.

3. **High Administrative Cost:** Banks have to open controlling and supervision centers at different locations to manage and supervise the branch operations. This may increase administrative cost.
4. **Red-tapism:** There is a possibility of red-tapism and delay in banking activities. Loan application may not be addressed in time which adversely affects the business

2.8.3 Group Banking

Under this banking system, a group of banks is brought under the control of one holding company. The holding company usually holds the majority of shares in the companies under its control and the companies whose shares are held are known as subsidiary or associated companies. The banks forming a group may be of unit banks or branch banks or both. Each bank under the group banking has its own identity and management. However, the holding company plays a dominating role in policy decisions.

Advantages:

(a) Pooling of resources: The parent holding company pools large resources of all the banks and these fund can be used more profitably.

(b) Better Fund Management: As the banks are under same group, their activities are coordinated and one bank may transfer money to others in times of necessity. Thus, better fund management is possible.

(c) Benefit of Large Scale Operations: Banks under this system get the advantages of large scale operations and are in a position of reducing the cost.

(d) Benefits without merger: Under this system, the banks are having their own identity and enjoy all the benefits of large scale operation without any merger.

(e) Avoids competition: As the banks under this system belong to the same group, they do not go for any unhealthy competition among themselves.

Disadvantages:

1. **Monopoly:** The group banking may encourage monopoly in banking over time which may not be a healthy trend.
2. **Possibility of Conflicts:** There is a possibility of conflicts among the individual unit banks due to different level of profits, benefits to employees and difference in policies at times.

2.8.4 Chain Banking

Chain banking system is mostly seen in the U.S.A. Under this system, same individual or a group of individuals control two or more banks by holding majority shares of these banks. The individual or group of individuals appoint their own directors or act as directors of different units. In this way, the unit banks whose shares are held by few individuals may form a chain and reap the benefits like group banks. These banks have the same advantages and disadvantages as that of group banking.

2.8.5 Universal Banking

Universal banking is a combination of commercial banking, investment banking, development banking, insurance and many other financial activities. It is a place where all financial products are available under one roof. So, a universal bank is a bank which offers commercial bank functions plus other functions such as Merchant Banking, Mutual Funds, Factoring, Credit cards, Housing Finance, Auto loans, Retail loans, Insurance, etc. Universal banking is done by very large banks. These banks provide a lot of finance to many companies. So, they take part in the Corporate Governance (management) of these companies. These banks have a large network of branches all over the country and all over the world. They provide many different financial services to their clients.

In India, two reports in 1998 mentioned the concept of universal banking. Those are, the Narasimham Committee Report and the S.H. Khan Committee Report. Both these reports advised to consolidate the banking industry through mergers and integration of financial activities. They advised for the combination of all banking and financial activities and suggested for Universal banking. In 2000, ICICI asked permission from RBI to become a universal bank. RBI wants some big domestic financial institutions to become universal banks.

Advantages of Universal Banking

The advantages of universal banking are:

1. **Economies of Scale:** Universal banking results in economic efficiency as it results in lower costs, higher output and better products and services. In India, RBI is in favour of universal banking because it results in economies of scale.
2. **Resource Utilization:** Universal banks use their client's resources as per the client's ability to take a risk. If the client has a high risk taking capacity then the universal bank will advise him to make risky investments. Similarly, clients with a low risk taking capacity are advised to make safe investments with lower risk. Today, universal banks invest their client's money in different types of Mutual funds and also directly into the stock market.
3. **Profitable Diversification:** Universal banks diversify their activities. So, they can use the same financial experts to provide different financial services. This saves cost for the universal bank.
4. **Easy Marketing:** The universal banks can easily market their financial products and services through their branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. ICICI Bank may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done

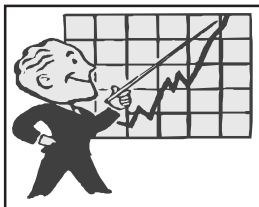
very easily because they use one brand name (ICICI) for all their financial products and services.

5. **One-stop Shopping:** Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and transaction costs. It also increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.

Disadvantages of Universal Banking

The disadvantages of universal banking are:

1. **Different Rules and Regulations:** Universal banking offers all financial products and services under one roof. However, all these products and services have to follow different rules and regulations. This creates many problems. e.g. Mutual Funds, Insurance, Home Loans, etc. have to follow different sets of rules and regulations, but they are provided by the same bank.This creates dissatisfaction among customers.
2. **Effect of failure on Banking System:** Universal banking is done by very large banks. If these huge banks fail, there will be heavy loss and adverse effect on the banking system as a whole. The confidence of the public may get shattered in such cases.
3. **Conflict of Interest:** Combining commercial and investment banking can result in conflict of interest. That is, Commercial banking versus Investment banking. Some banks may give more importance to one type of banking and give less importance to the other type of banking. However, this does not make commercial sense.



CHECK YOUR PROGRESS

Q3: Define group banking.

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2.9 LET US SUM UP

In this unit we have discuss the following:

- Commercial banks pool the savings of the household who have surplus (savings) and lends the money to the various users in form of loans.
- Commercial banks perform three major roles. These are: Financial Intermediary, Constituent of the Payment System and Financial Services Provider.
- Banks can be classified into various categories on the basis of Functions, Second schedule of the Reserve Bank of India Act, Domicile, Ownership, and Organization structure.
- The private sector banks include both scheduled commercial banks and non-scheduled commercial banks.
- In India, two reports in 1998 mentioned the concept of universal banking. Those are, the Narasimham Committee Report and the S.H. Khan Committee Report.



2.10 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.



2.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Private Sector Banks are those Banks where the management is controlled by Private individuals and Government does not have any say in the management of these banks.

Ans to Q No 2: Domestic banks are banks which are registered or incorporated in India.

Ans to Q No 3: Under this banking system, a group of banks is brought under the control of one holding company.

2.12 MODEL QUESTIONS

Q 1: Define unit banking and explain its advantages and disadvantages.

Q 2: Discuss the merits and demerits of group banking.

Q 3: Who is an indigenous banker? State the defects of indigenous banking system.

Q 4: 'Universal Banking has a broad and integrated approach non banking'. Comment.

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UNIT 3 : E-BANKING SOLUTIONS

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Meaning

3.4 Electronic Payment System (EPS)

3.5 Plastic Money

3.6 Electronic Money Transfers

- 3.6.1 Real Time Gross Settlement
- 3.6.2 National Electronic Funds Transfer
- 3.6.3 Electronic Funds Transfer
- 3.6.4 Electronic Cheque Payment

6.7 Core Banking Solution (CBS)

6.8 Payment Gateway

6.9 Electronic Payment Security

6.10 Benefits of E-Banking

6.11 Disadvantages of E-Banking

3.12 Let Us Sum Up

3.13 Further Reading

3.14 Answers to Check Your Progress

3.15 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain the online payment mechanism
- describe the electronic payment system
- explain the electronic payment security.

3.2 INTRODUCTION

The evolution of e-banking is recent technological advancement. Various electronic modes of providing banking products are evolved and

gained popularity in recent past, such as, tele-banking, Automated Teller Machines, credit card, debit card, forex card, internet banking etc. The most recent one is e-banking that has major impact on the financial market.

In this unit we will discuss electronic banking, Online Payment Mechanism, Electronic Payment System etc.

3.3 MEANING

E-banking is an electronic consumer interface and an alternative channel of distribution for banking services and products. E-banking is a process through which banking consumers manage their banking transaction through internet without even visiting a bank branch.

Application of IT in banking industry has reduced the time of bank transactions and speed up the communication system between bank and its customers. Today e-banking is the most popular delivery system in banking industry. It is the need of hour to extend e-banking services to banking customers so that bank can maximize the benefits for banks as well as for its customers. The importance of e-banking is growing day by day as it maximizes the advantage for banks and its clients. Even been a costly and risky affair, bank and financial institutions largely investing in latest technology. In the following discussion we will discuss some new modes of providing banking services.

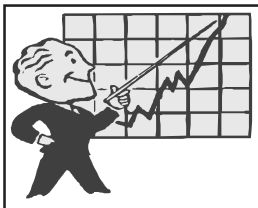
3.4 ELECTRONIC PAYMENT SYSTEM (EPS)

An electronic payment (e-payment) system is a way of making transactions or paying for goods and services through an electronic medium, without the use of cheque or cash. These days, mobile ATM is also an area of focus. Banks are opening such mobile ATMs which double as mobile branches besides offering customers the facility of using their debit/ATM cards as the ATMs are installed in mobile vans.

Advantages of Electronic Payment System

The various factors that have lead the financial institutions to make use of electronic payments are:

1. Decreasing technology cost: The technology used in the networks is decreasing day by day, which is evident from the fact that computers are now dirt -cheap and Internet is becoming free almost everywhere in the world.
2. Reduced operational and processing cost: Due to reduced technology cost the processing cost of various commerce activities becomes very less e.g. in electronic transactions we save both paper and time.
3. Increasing online commerce: The above two factors have lead many institutions to go online and many others are following them.



CHECK YOUR PROGRESS

Q 1: Explain the meaning of electronic payment system.

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3.5 PLASTIC MONEY

Plastic money is a term that is used predominantly in reference to the hard plastic cards we use every day in place of actual bank notes. They can come in many different forms such as cash cards, credit cards, debit cards, pre-paid cash cards and store cards.

Cash cards- A card that will allow you to withdraw money directly from your bank via an Automated Teller Machine (ATM) but it will not allow the holder to purchase anything directly with it.

Credit cards- A credit card is a plastic card that represents a line of credit. A line of credit is an account with money that you can borrow repeatedly. In most cases, this is not going to be your money. It is going to come from a credit card issuer like SBI,ICICI Bank etc. Again this card will permit the card holder to withdraw cash from an ATM, and allow the user to purchase goods and services directly, but unlike a cash card the money is basically a high interest loan to the card holder.

The money you spend on a credit card has to be paid back. If you do not make your payments by a certain day of the month, you will have to pay

interest, and potentially a late fee.

Debit cards- This type of card will directly debit money from your bank account and can directly used to purchase goods and services. While there is not official credit facility with debit cards, as it is linked to the bank account the limit is the limit of what is in the account, for instance if an overdraft facility is available then the limit will be the extent of the overdraft.

Pre- paid cash cards- As the name suggests the user will add credit to the card themselves, and will not exceed the amount. These are usually re-useable in that they can be 'Topped up' however some cards, usually marketed as gift Cards are not re-useable and once the credit has been spent they are disposed of.

Store Cards- These are similar in concept to the credit card model, in that the idea is to purchase something in store and be billed for it at the end of the month. These cards can be charged at a very high interest rate and can limited in the places they can be used, sometimes as far as only the store brand that issued it.

3.6 ELECTRONIC MONEY TRANSFERS

Following are the some methods of electronic money transfer

3.6.1 Real Time Gross Settlement

Real Time Gross Settlement, which can be defined as the continuous (real-time) settlement of funds individually on an order by order basis (without netting). 'Real Time' means the processing of instructions at the time they are received rather than at some later time. 'Gross Settlement' means the settlement of funds transfer instructions occurs individually (on an instruction by instruction basis). The RTGS system is primarily meant for large value transactions. The RTGS is primarily meant for large value transaction. The minimum amount to be remitted through RTGS is Rs 2 lakh. The maximum limit is Rs 10 lakh per day. RTGS is not a 24x7 system. The RTGS service window for customer transactions

is available to banks from 7 am to 6 pm on a working day, for settlement at the RBI end. However, the timings that the banks follow may vary from bank to bank.

3.6.2 National Electronic Funds Transfer

National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. 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.

The NEFT system takes advantage of the core banking system in banks. Presently, NEFT operates in hourly batches - there are eleven settlements from 9 am to 7 pm on week days (Monday to Friday) and five settlements from 9 am to 1 pm on Saturdays. Under retail internet banking, there is no limit - either minimum or maximum - on the amount of funds that could be transferred using NEFT.

IFSC or Indian Financial System Code is an alpha-numeric code that uniquely identifies a bank-branch participating in the NEFT system. This is an 11 digit code with the first 4 alpha characters representing the bank, and the last 6 characters representing the branch. The 5th character is 0 (zero). IFSC is used by the NEFT system to identify the originating / destination banks / branches and also to route the messages appropriately to the concerned banks / branches.

NEFT is an electronic fund transfer system in which the transactions received up to a particular time are processed in batches. Contrary to this, in RTGS, the transactions are processed continuously on a transaction by transaction basis throughout the RTGS business hours.

3.6.3 Electronic Funds Transfer

Before describing cheques payment in e-commerce it is necessary to describe a scheme called Electronic Funds Transfer

(EFT) which is an essential part of clearing cheques in a banking system. What is meant by clearing a cheque? If A issues a cheque favouring B, it will be written on a cheque in bank A's bank (say X). B will deposit the cheque in his or her bank (say Y). Before B's account in bank Y can be credited, Y should check with A's bank X whether A has enough money in his or her account. If X approves then A's account in bank X will be debited and B's account in bank Y will be credited. This process of cheques clearance has been automated and is called Electronic Funds Transfer. In order to implement electronic funds transfer, the following requirements have to be met:

- An Automated Clearing House (ACH) should work as an intermediary to negotiate transfer of funds when cheques are used. In India, the Reserve Bank of India (RBI) acts as the ACH.
- All banks should use ACH and become its members. RBI is the controlling agency of all banks in India.
- There should be a secure electronic communication channel between each bank and the ACH. As the amounts involved are very large, normally these channels are private secure leased lines.

There are two models of EFT. The first one is *Automated Cheque Clearance* where physical cheques are transported and the second a variation called *Electronic clearing Service (ECS)* where no physical cheques are transported.



CHECK YOUR PROGRESS

Q 2: What is a debit card?

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3.6.4 Electronic Cheque Payment

In B2B e-commerce the purchaser and the vendor normally have mutual trust before negotiating a purchase. The amount involved

is also quite large. Thus, payments are normally made by cheque. Thus we have to find an electronic equivalent of a physical cheque and payment scheme to mimic the manual scheme. We thus need banks and ACH to accept electronic cheques in addition to physical cheques. Assuming this condition is satisfied we will describe a method.

Before electronic cheques payment system is implemented, the following conditions must be satisfied:

1. Both businesses must have certified public keys and must be able to digitally sign e-cheques. In India every registered company (Private or Public limited) must have a public key certificate and must be able to digitally sign documents. Income Tax department accepts only e-returns and electronic payments of tax due from all companies.
2. All banks and ACH must have public key certificates and must be able to digitally sign documents using a common agreed hash function.

There are five parties involved in the transaction.

1. Purchaser -P
2. Vendor-V
3. Purchaser's bank-PB
4. Vendor's bank-VB
5. Automated clearing house-ACH

One format for e- cheque is given below which contains all the essential information.

Format of e-cheque sent by purchaser (payer)

Unique id of e-cheque

Date of cheque

Payee's id and name

Amount to be paid

Payer's bank code

Payer's account number

Digital signature of payer

3.7 CORE BANKING SOLUTION (CBS)

Core Banking Solution (CBS) is networking of branches, which enables customers to operate their accounts, and avail banking services from any branch of the bank on CBS network, regardless of where he maintains his account. The customer is no more the customer of a branch. He becomes the bank's customer. Thus CBS is a step towards enhancing customer convenience through anytime banking.

Advantages of CBS

All CBS branches are inter-connected with each other. Therefore, customers of CBS branches can avail various banking facilities from any other CBS branch located anywhere in the world. These services are:

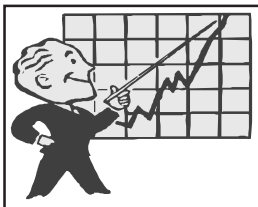
- To make enquiries about the balance; debit or credit entries in the account.
- To obtain cash payment out of his account by tendering a cheque.
- To deposit a cheque for credit into his account.
- To deposit cash into the account.
- To deposit cheques/cash into the account of some other person who has account in a CBS branch.
- To get statement of account.
- To transfer funds from his account to some other account-his own or of third party, provided both accounts are in CBS branches.
- To obtain demand drafts or banker's cheques from any branch on CBS-amount shall be online debited to his account.
- Customers can continue to use ATMs and other delivery channels, which are also interfaced with CBS platform. Similarly, facilities like Bill Payment, I-Bob, M-bob etc. shall also continue to be available.
- Internet banking facility.

  The aim of all these services is to provide convenient, efficient, and high quality banking experience to the customers, comparable to world-class standards.

CBS provides some other benefits also. These are:

- Improves the quality and efficiency of the services.

- Provides convenient and delightful banking.



CHECK YOUR PROGRESS

Q 3: What is meant by Core Banking Solution?

.....

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3.8 PAYMENT GATEWAY

A payment gateway is a separate service and acts as an intermediary between the merchants' shopping cart and all the financial networks involved with the transaction, including the customers' credit card issuer and your merchant account. It checks for validity, encrypts transaction details, ensures they are sent to the correct destination and then decrypts the responses which are sent back to the shopping cart. A payment gateway can be thought of as a digital equivalent to a credit card processing terminal.

This is a seamless process and your customer does not directly interact with the gateway; as data is forwarded to the gateway via your shopping cart and a secure (SSL) connection. The shopping cart is configured via plugins to sent information that is acceptable to the particular gateway. Paytm, Instamojo, Cashfree, PayPal, Citrus etc. are some examples of popular payment gateway.

How payment gateways work- Payment gateways encrypt information handled through SSL (Secure socket layer). This prevents opportunity for fraud, and adds security to the transaction process. Gateways communicate with a variety of entities, including:

- The customer
- The merchant (through their website)
- Credit Card companies (by verifying information)
- Internet Merchant accounts that relay order information from the gateway to the merchant's bank account.

Benefits of payment gateway-

Benefits of having a payment gateway are:

1. **Security:** Gateways keep customers credit card data behind firewalls so that the merchant doesn't have to worry about someone "hacking in" to their system.
2. **Encryption:** Gateways use SSL encryption to prevent message tampering while the credit card information is being transmitted over the Internet. EMS provides the most secure encryption technology.
3. **Back-up redundancy:** Gateways have a backup system in place to ensure that merchants can continue processing in the event of an emergency
4. **Up-to-date technology:** Gateways are services that are constantly upgraded to be up to date with the latest technology. And, because the gateways are not on merchants' computers, there is no need for the merchants to upgrade their hardware. Gateways save the cost of an additional phone line that would be needed in a dial application.



CHECK YOUR PROGRESS

Q 4: Give two examples of payment gateway?

.....

.....

3.9 ELECTRONIC PAYMENT SECURITY

The well-known security problems of traditional payment systems are as follows:

- Money can be counterfeited.
- Signatures can be forged.
- Cheques can bounce.

Electronic payment systems have the same problems as traditional systems, and more:

- Digital documents can be copied perfectly and arbitrarily often.
- Digital signatures can be produced by any body who knows the private key.
- A payer's identity can be associated with every payment transaction.

Obviously, without additional security measures, widespread e-commerce is not viable. A properly-designed electronic payment system can, however, provide better security than traditional payment systems, in addition to flexibility of use.

Generally, in an electronic payment system, three types of adversaries can be encountered:

1. Outsiders eavesdropping on the communication line and misusing the collected data (e.g., credit card numbers)
2. Active attackers sending forged messages to authorized payment system participants in order to prevent the system from functioning or to steal the assets exchanged (e.g., goods, money).
3. Dishonest payment system participants trying to obtain and misuse payment transaction data that they are not authorized to see or use.

The basic security requirements for electronic payment systems can be summarized as follows:

- Payment authentication.
- Payment integrity.
- Payment authorization.
- Payment confidentiality.

Payment authentication implies that both payers and payees must prove their payment identities, which are not necessarily identical to their true identities. If no anonymity is required, any authentication mechanisms may be used to satisfy this requirement. Authentication does not necessarily imply that payer's identity is revealed. If anonymity is required, some special authentication mechanisms are needed.

Payment integrity requires that payment transaction data cannot be modifiable by unauthorized principals. Payment transaction data includes the payer's identity, the payee's identity, the content of the purchase, the amount, and possibly other information. For this purpose an integrity mechanism from the area of information security may be employed.

Payment authorization ensures that no money can be taken from a customer's account or smart card without his explicit permission. It also means electronic payment systems require that the explicitly allowed amount

can be withdrawn by the authorized principal only. This requirement is related to access control.

Payment confidentiality covers confidentiality of one or more pieces of payment transaction data. In the simplest case it can be achieved by using one of the communication confidentiality mechanisms. In some cases, however, it is required that different pieces of the transaction data are kept secret from different payment system participants. Such requirements can be satisfied by certain specially tailored payment security mechanisms.

3.10 BENEFITS OF E-BANKING

Advent of E-banking has brought many advantages to the customers. Some of them are discussed bellow-

Benefits to Customers: Bank customers have been significantly gained from E-banking. All most all banking tasks have now been fully automated resulting in greater eases and comfort to the customers. Now a day's Customer's account is extremely accesses able with internet. Through internet banking customer can operate his account while sitting in his office or home. There is no need to go to the bank in person for such matter. Customer can withdraw at any time through ATMs. Besides withdrawing cash customers can also have mini banks statements, balance inquiry, fund transfer, deposit at these ATM. E banking has also greatly helped in payment of utility bill. Now there is no need to stand in long queues outside the counters. The growth of credit card usage also owes greatly to E-banking. Now a customer can shop worldwide without carrying cash. Banking services are available 24 hours a day, seven days a week and they are only a mouse click away.

Benefits to Banking Industry: Banking industry has immensely benefited due to growth of E-Banking infrastructure. The growth of E-banking has greatly helped the banks in controlling their overheads and operating cost. Adoption of E-banking has resulted greater efficiency, better time usage and enhanced control.

The rise of E-banking has made banks more competitive. It has also led to expansion of the banking industry, opening of new avenues for

banking operations. Electronic banking has greatly helped the banking industry to reduce paper work, thus helping them to move the paper less environment.

3.11 DISADVANTAGES OF E-BANKING

Although e-banking system provides a numerous advantages but there are many disadvantages of e-banking. Even after investing heavily in e-banking awareness campaign and offering so many benefits through e-banking system, still it lacks in gaining trust factor among its customers. The disadvantages of e-banking system are as follows:

1. **Impersonal:** Invent of E-banking solutions reduce face to face interaction between bankers and customers and makes it very impersonal. Thus, customers who are more comfortable in dealing with people in physical bank setting that provide those personalized services rather than mechanical interaction; e-banking is not a good option for them.
2. **Lack of trust:** Though E-banking is widely used, still many customers do not trust online mode of service especially for money related transactions. Users who are not seasoned in e-banking feel very uncomfortable as they have doubt regarding the correctness of the transaction done by them online.
3. **Difficult for first timers:** For the beginners, it appears as a complex mode of service as customer find it complicated to navigate through bank's website. While opening an account online, bank's website requires a number of information and that seems time taking and inconvenient process to the first time users.
4. **Security:** There is always risk of fraud when we use internet. The hackers may clone the electronic devices, website and steal passwords. People generally hesitate to have an online bank account due to such security risk involved in it. Although, it is not a big issue for banks providing e-banking services, as they prioritize security. To avoid security risk, banks use the most advanced security system in protecting their websites.

5. Other disadvantages of E-Banking:

(a) If there is no internet facility, poor network or bank's server is down e-banking facility cannot be used.

(b) To use internet banking, customer is compelled to have a smart phone or computer with internet access.

(c) There is always the possibility of a hacker gaining access to customer's account.

(d) Banks do not train customers how to use online banking.

(e) Banks bears heavy costs to install high firewall.

(g) E-banking promotes lack of socializing or social contacts.



3.12 LET US SUM UP

In this unit we have discuss the following:

- E-banking is an electronic consumer interface and an alternative channel of distribution for banking services and products.
- National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer.
- A payment gateway is a separate service and acts as an intermediary between the merchants' shopping cart and all the financial networks involved with the transaction, including the customers' credit card issuer and your merchant account.
- Although e-banking system provides a numerous advantages but there are many disadvantages of e-banking.



3.13 FURTHER READING

1) Essentials of E-commerce Technology, - V. Rajaraman, PHI.

2) E-commerce, - Ritendra Goel, New age international publishers.

3) E-Business and E-commerce for manager's, - Harvey M. Deitel, Paul J. Deitel, Kate Steinbuhler, Pearson.

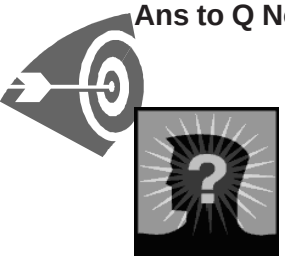
3.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Electronic payment systems are online payment systems. The goal of their development is to create analogs of checks and cash on the Internet.

Ans to Q No 2: card will directly debit money from your bank account and can directly used to purchase goods and services.

Ans to Q No 3: Core Banking Solution (CBS) is networking of branches, which enables Customers to operate their accounts, and avail banking services from any branch of the Bank on CBS network, regardless of where he maintains his account.

Ans to Q No 4: Paytm and Instamojo.



3.15 MODEL QUESTIONS

Q 1: Explain various features and advantages of electronic payment system.

Q 2: What is plastic money?

Q 3: Write short notes on:

(i) Electronic cash (iii) Store cards

(ii) Credit card (iv) CBS

Q 4: Discuss the advantages and disadvantages of e-banking.

Q 5: What is payment gateway? List the benefits of payment gateway.

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UNIT 4 : BANKER CUSTOMER RELATIONSHIP

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Definition of Banker and Customer

4.4 Relationship between Banker and Customer

- 4.4.1 Relationship of Debtor and Creditor
- 4.4.2 Relationship of Creditor and Debtor
- 4.4.3 Relationship of Trustee and Beneficiary
- 4.4.4 Relationship of Bailee and Bailor
- 4.4.5 Relationship of Agent and Principal

4.5 Rights of Banker

4.6 Obligations of Banker

4.7 Duties of Paying Banker

4.8 Duties of Collecting Banker

4.9 Know Your Customer (KYC) Guidelines

4.10 Let Us Sum Up

4.11 Further Reading

4.12 Answers To Check Your Progress

4.13 Model Questions

4.1 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.

4.2 INTRODUCTION

As soon as we open an account in a bank or the banker issue 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. In unit 9, we have discussed the commercial banks, their functions, different types of banks and the role played by the banks in the economic development of a country. Now it will be appropriate to focus 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.

4.3 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 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 is 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.

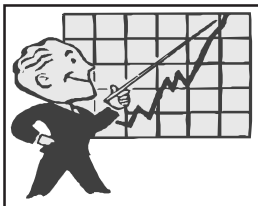
According to Sir John Paget, "To constitute a customer, there must be some recognizable course or habit of dealing in the nature of regular banking business…..".

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 ant 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.

4.4 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.

4.4.1 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 a customer deposit 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. However, with the advent of technology, this feature is not applicable in all the time.

4.4.2 Relationship of Creditor and Debtor

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

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

Overdrawing the account: In Unit 9, 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. 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).



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

4.4.3 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.

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.

4.4.4 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.

4.4.5 Relationship of Agent and Principal

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 theses 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

Q 2: 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 ……..

4.5 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.



Lien: The right of the creditor to hold property of the debtor till the debt is cleared.

- **Banker's lien:** 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.



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

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

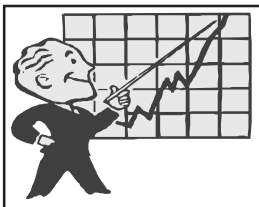
The garnishee order is issued in two phases. First, 'order nisi' is issued directing the garnishee (banker) not to make any payment from the account of the garnishee debtor. The garnishee is asked to give his reply in the court whether the funds in the account of the garnishee debtor can be appropriated 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.

4.6 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

Q 3: 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.

4.7 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 have 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 customer.

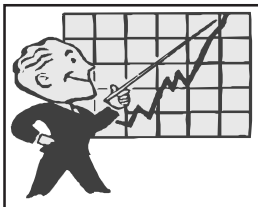
In this connection, let us discuss the duties of the paying banker. The duties include the precautions that the paying banker must take at the time of honouring the customers' cheques.

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 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

Q 4: State two duties of the paying banker.

i. ……

ii. ……

4.8 DUTIES OF THE COLLECTING BANKER

After discussing the duties of the paying banker, now we are going to discuss 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

Q 5: State two duties of the collecting banker.

i. .....

ii. .....

4.9 KNOW YOUR CUSTOMER (KYC) GUIDELINES

KYC means “Know Your Customer”. It is a process by which banks obtain information about the identity and address of the customers. This process helps to ensure that banks’ services are not misused. The KYC procedure is to be completed by the banks while opening accounts and

also periodically update the same.

The KYC guidelines have been put in place by the Reserve Bank of India in the context of the recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on Combating Financing of Terrorism (CFT). The Prevention of Money Laundering Act requires banks, financial institutions and intermediaries to ensure that they follow certain minimum standard of KYC and AML. 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.

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.

Banks are entitled to refuse to open an account or discontinue an existing relationship if there is failure tomeet the minimum KYC requirements. However, there isflexibility provided to certain categories of customer who are unable to provide the necessary document at the time of account opening.



CHECK YOUR PROGRESS

Q 6: State two objectives of 'Know Your Customer Guidelines'?

i. .....

ii. .....



4.10 LET US SUM UP

In this unit we have discussed the following-

- 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.
- The obligations of the banker which arises because of the banker-customer relationship.
- 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.



4.11 FURTHER READING

1) Practice and Law of Banking by B.S. Khubchandani.

2) Indian banking by S. Natarajan & R. Parameswaran.

4.12 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 crossed cheques.

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.

4.13 MODEL QUESTIONS

Q 1: Define the 'banker'.

Q 2: Define the 'customer'.

Q 3: Discuss the features of debtor creditor relationship between the banker and the customer.

Q 4: Discuss the duties of the paying banker.

Q 5: Discuss the duties of the collecting banker.

Q 6: Write short notes-

i. Bailee- Bailor relationship between banker and customer

ii. KYC Guidelines.

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UNIT 5: OPERATION OF BANK DEPOSIT ACCOUNTS

UNIT STRUCTURE

5.1 Learning Objectives
5.2 Introduction
5.3 Types of Bank Deposits
5.4 Fixed Deposit Account
5.5 Savings Deposit Account
5.6 Current Account
5.7 Recurrring Deposit Account
5.8 Fixed Deposit Linked Savings Account
5.9 Procedure of Opening Account
5.10 Operation of Bank Accounts
5.11 Pay-in- Slip
5.12 Withdrawal Slip and Cheque Book
5.13 Pass Book
5.14 Let Us Sum Up
5.15 Further Reading
5.16 Answers to Check Your Progress
5.17 Model Questions

5.1 LEARNIG OBJECTIVES

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

- understand the nature of deposit accounts
- know about the various types of deposit accounts
- know the procedure of opening bank accounts
- explain the concept of KYC and the KYC requirements
- understand the method of maintaining pass book
- deal with pay-in-slip, withdrawal slip and cheque book.

5.2 INTRODUCTION

You are aware that banks accept deposits from the public and this is one of the primary function of the commercial banks. The banks provide

various types of accounts through which the banks accept money from the public. These accounts are fixed deposit, savings deposits, current accounts etc. The procedure of opening and operating the various types of account is different. The banks offer different rate of interest in these accounts. All these aspects will be discussed in this unit.

5.3 TYPES OF BANK DEPOSITS

We know that, the basic function of a commercial bank is to accept bank deposits which are withdrwable on demand and use of those funds by lending to various user groups.Deposits received by banks are known as bank deposits. The depositors being the provider of fund are creditors and the bank becomes debtor for the said amount. The account holder or customer retains the right to have their money repaid on demand subject to restrictions imposed as per the terms and conditions of the account. The customer may or may not be able to pay money into or out of the account by cheque, internet banking, or other channels, depending on those terms and conditions agreed upon. Banks maintain record for each depositor in form of account and thus the account maintained for each deposit is a deposit account. The deposits and withdrawals from time to time are recorded on the bank's books, and the resulting balance is recorded as a liability for the bank and represents the amount owed by the bank to the customer. A deposit account may be broadly classified into three types viz. (i) fixed deposit account, (ii) savings deposit account, and (iii) current account. However, there are some modified versions or hybrid type of deposit accounts seen in recent years, due to ever increasing competition and need of people. Some banks have introduced new products, which combine the features of two or more types of deposit accounts. These are known by different names in different banks, e.g 2-in-1 Deposits, Smart Deposits, Power Saving Deposits, Automatic Sweep Deposits etc. Banks employ the funds received from its depositors and earn interest on it. Accordingly they pay interest on the deposits to their depositors. In some cases they also charge for the service provided to their customers.

5.4 FIXED DEPOSIT ACCOUNT

All Banks offer fixed deposits schemes with a wide range of tenures for periods ranging from 7 days to 10 years. These are popularly known as Fixed Deposit (FD) or Term Deposit (TD) accounts. The term "fixed" in Fixed Deposits denotes the period of maturity. Therefore, the depositors are supposed to continue such Fixed Deposits for the length of time for which the depositor decides to keep the money with the bank. However, in case of need, the depositors can ask for closing (or breaking) the fixed deposit prematurely by paying a penalty (usually of 1%, but some banks either charge less or no penalty). Some banks have variable interest fixed deposit schemes also where the rate of interest on such deposits varies with the prevalent market rates i.e. it will go up if market interest rate goes and it will come down if the market rates fall. However, such types of fixed deposits have not gained popularity so far. The rate of interest for Fixed Deposits differs from bank to bank. The present trends indicate that private sector and foreign banks offer higher rate of interest. Banks also offer loan against FDs and the interest charged on such loans may be one or two percent higher than the interest on offered such deposits.

5.5 SAVINGS DEPOSIT ACCOUNT

These deposits accounts are one of the most popular deposits for individual . These accounts not only provide cheque facility but also have lot of flexibility for deposits and withdrawal of funds from the account. Most of the banks have rules for the maximum number of withdrawals in a period and the maximum amount of withdrawal. The interest on Saving Bank Accounts was regulated by RBI . However, with effective from 25th October, 2011, RBI has deregulated Saving Bank Account interest rates and now banks are free to decide the same within certain conditions imposed by the RBI. Under the directions of RBI, now banks are also required to open No Frill Accounts. No frill accounts do not have any minimum balance requirements and meant for weaker sections of people who cannot afford to have a bank account because of the minimum deposits required. Although

public sector banks still pay only 4% rate of interest, some private banks like Kotak Bank and Yes Bank pay more on such deposits.

5.6 CURRENT ACCOUNT

Current Accounts are basically meant for businessmen and are never used for the purpose of investment or savings. These deposits are the most liquid deposits and there are no limits for number of transactions or the amount of transactions in a day. Most of the current accounts are opened in the names of firm/company accounts. Cheque book facility is provided and the account holder can deposit all types of the cheques and drafts in their names. No interest is paid by banks on these accounts. In some cases, banks even charge certain service charges, on such accounts. The important features of Current Accounts are as follows:

a. The main objective of Current Account holders in opening this type of account is to enable them to conduct their business transactions smoothly.

b. There are no restrictions on the number of times of deposits in cash or cheques.

c. Usually banks do not pay any interest on such current accounts. However, in recent times some banks have introduced special current accounts where interest (as per banks' own guidelines) is paid.

d. The current accounts do not have any fixed maturity as these are on continuous basis accounts.

5.7 RECURRING DEPOSIT ACCOUNT

These are popularly known as RD accounts and are a kind of term deposits. This type of account is specially designed for the people who do not have lump sum amount of savings to make investment in a fixed deposit scheme, but are ready to save a small amount every month over a longer period. People having regular flow of income and capable of saving can opt for such deposits. Normally, such deposits earn interest on the amount already deposited (through monthly installments) at the same rates as are applicable to Fixed Deposits / Term Deposits. These are best if one wish to create a fund for some future use.

Under these types of deposits, the person has to usually deposit a fixed amount of money every month. Any default in payment within the month attracts a small penalty. However, some Banks besides offering a fixed installment RD, have also introduced a flexible / variable RD. Under these flexible RDs the person is allowed to deposit even higher amount of installments, with an upper limit fixed for the same e.g. 10 times of the minimum amount agreed upon. These accounts can be funded by giving Standing Instructions by which bank withdraws a fixed amount on a fixed date of the month from the saving bank account of the customer and the same is credited to RD account.

Recurring Deposit accounts are normally allowed for maturities ranging from 6 months to 120 months. A Pass book is usually issued where in the person can get the entries for all the deposits made by him / her and the interest earned. Banks also indicate the maturity value of the RD assuming that the monthly installments will be paid regularly on due dates.
In case installment is delayed, the interest payable in the account will be reduced and some nominal penalty may be charged for default in regular payments. Premature withdrawal of accumulated amount is also permitted with charge of a penalty. These accounts can be opened in single or joint names. Nomination facility is also available.

The RD interest rates paid by banks in India are usually the same as payable on Fixed Deposits, except when specific rates on FDs are paid for particular number of days e.g. 500 days, 555 days, 1111 days etc i.e. these are not ending in a quarter.

5.8 FIXED DEPOSIT LINKED SAVINGS ACCOUNT

Most of the banks have come with a hybrid type of accounts i.e. a combination of savings deposit and fixed deposit. These types of accounts are preferred by the depositors as it gives liquidity of a savings account as well as higher interest of a fixed deposit. These are known in different names in different banks like Two-in-One account, Multiple Option Deposit (MOD) account, Flexible Deposit Accounts, Auto Sweep account etc. Under this scheme, the excess amount of deposits over a specified amount in the

savings account is swept to the fixed deposit accounts for a default period of one year. The deposit accounts carry the FD interest rate as applicable to that time. Whenever any withdrawal is made and if the balance in the savings account falls short, automatically the amount is swept from the latest fixed deposit account and credited to the savings bank account. All the conditions of interest and premature closures as applicable to FDs are applicable in such cases.



CHECK YOUR PROGRESS

Q 1: In which type of deposit account the rate of interest offered is highest?

A. Current deposit account

B. Savings Deposit Account

C. Fixed Deposit Account

Q 2: Recurring Deposit is a type of:

A. Current Deposit Account

B. Savings Deposit Account

C. Fixed Deposit Account

B. Combination of Fixed and Savings Deposit Account.

5.9 PROCEDURE OF OPENING ACCOUNT

Receipt of Application: A person who wants to open a bank account has to apply for the same in a prescribed format obtainable from the concerned bank. The application form contains various columns on personal information, address, occupation, status etc. The applicant has to affix his passport size photograph and give specimen signature under which the account shall be operational. The applicant has to submit necessary documents along with the application. These are discussed in the subsequent sections.

Due Diligence Process: A bank before opening any deposit account has to carry out due diligence as required under “Know Your Customer” (KYC) guidelines issued by RBI and such other norms or procedures adopted

by the bank.The 'due diligence' process, while opening a deposit account, involves the bank having adequate knowledge of the person's identity, occupation, sources of income, and location. Obtaining an introduction of the prospective depositor from a person acceptable to the bank, obtaining recent photographs of people opening/ operating the account are part of the due diligence process. For customers providing proof of identification and address, there is no need for personal introduction to the bank for opening of a new savings bank account. To promote financial inclusion in rural areas, KYC norms have been relaxed for below the poverty line (BPL) families.

Know Your Customer: KYC means "Know Your Customer". It is a process by which banks obtain information about the identity and address of the customers. This process helps to ensure that banks' services are not misused. The KYC procedure is to be completed by the banks while opening accounts and also periodically update the same.

To open a bank account, one needs to submit a 'proof of identity and proof of address' together with a recent photograph. The Government of India has notified six documents as 'Officially Valid Documents' (OVDs) for the purpose of producing proof of identity. These six documents are Passport, Driving Licence, Voters' Identity Card, PAN Card, Aadhaar Card issued by UIDAI and NREGA Card. You need to submit any one of these documents as proof of identity. If these documents also contain your address details, then it would be accepted as as 'proof of address'. If the document submitted by you for proof of identity does not contain address details, then you will have to submit another officially valid document which contains address details.

If one does not have any of the documents listed above to show 'proof of identity', can still open a bank account known as 'Small Account' by submitting his recent photograph and putting signature or thumb impression in the presence of the bank official. The 'Small Accounts' have certain limitations such as:

- balance in such accounts at any point of time should not exceed Rs.50,000
- total credits in one year should not exceed Rs.1,00,000
- total withdrawal and transfers should not exceed Rs.10,000 in a month.
- foreign remittances cannot be credited to such accounts.

Such accounts remain operational initially for a period of twelve months and there after, for a further period of twelve months, if the holder of such an account provides evidence to the bank of having applied for any of the officially valid documents within twelve months of the opening of such account. The bank will review such account after twenty four months to see if it requires such relaxation further.

If a person do not have any of the officially valid documents, a normal account can be opened by submitting a copy of any one of the following documents:

(i) Identity card with person's photograph issued by Central/State Government Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, and Public Financial Institutions; or

(ii) letter issued by a gazetted officer, with a duly attested photograph of the person.

This, however, is not a general rule and it is left to the judgment of the banks to decide whether this simplified procedure can be adopted in respect of any customer.

Minimum Balance: For deposit products like a savings bank account or a current account, banks normally stipulate certain minimum balances to be maintained as part of terms and conditions governing operation of such accounts. But for people below the poverty line, banks encourage the opening of 'No-frills Accounts', typically a special savings bank account where no minimum balance requirement is required. For a savings bank account, the bank may also place restrictions on number of transactions, cash withdrawals, etc., during a given period.

Transparency: Failure to maintain minimum balance in the accounts, where applicable, will attract levy of charges as specified by the bank from time to time. Similarly, the bank may specify charges for issue of cheques books, additional statement of accounts, duplicate passbook, folio charges, etc. All such details regarding terms and conditions for operation of the accounts and schedule of charges for various services provided should be

communicated to the prospective depositor while opening the account for the sake of transparency.

Eligibility: A savings bank account can be opened by eligible person(s) and certain organizations/agencies, as advised by the RBI from time to time. But current accounts can be opened by individuals, partnership firms, private and public limited companies, Hindu Undivided Families (HUFs), specified associates, society trusts, etc. Eligibility criteria for a savings account and a current account are largely similar, but there are important differences too. While both the accounts can be opened by individuals, the savings account cannot be opened by a firm. Term Deposit Accounts can be opened by all categories of account holders.

Requirement of PAN: In addition to the due diligence requirements, under KYC norms, banks are required by law to obtain a Permanent Account Number (PAN) from the prospective account holder or alternate declarations as specified under the Income Tax Act.

5.10 OPERATION OF BANK ACCOUNTS

The following points may be noted with regard to operation of bank accounts.

Operation of Single and Joint Account: Deposit accounts can be opened by an individual in his own name or by more than one individual jointly in their own names. When it is opened in the name of one individual it is known as single account and operated by him or by any authorized person. When it is in the name of more than one individual it is known as joint account. Account holders of a joint account can give mandates on the operation of the account, and the disposal of balances in the event of the demise of one or more of the holders. Banks classify these mandates as 'Either or Survivor', and 'Anyone or Survivor(s)', etc. The mandate for operation of the account can be modified with the consent of all account holders. Joint accounts opened by minors with their parents or guardians can be only operated by the latter.

Power of Attorney: At the request of the depositor, the bank can register power of attorney given by him authorizing another person to operate the account on his behalf.

Closure/renewal of deposits: Term-deposit account holders at the time of placing their deposits can give instructions with regard to closure of deposit account or renewal of deposit for further period on the date of maturity. In absence of such mandate, the bank will usually seek instructions from the depositor(s) as to the renewal of the deposit or otherwise by sending intimation before say, 15 days of the maturity date of the term deposit. If no mandate is given or received by the bank before the date of maturity of term deposit, the bank will be at liberty to roll over the deposit on due date.

Nomination: A depositor is permitted to officially authorize someone, who would receive the money of his account when the depositor passes away. This is called the nomination process. Nomination facility is available on all deposit accounts opened by individuals. Nomination is also available to a sole proprietary concern account. Nomination can be made in favour of one individual only. Nomination so made can be cancelled or changed by the account holder/s any time. Nomination can be made in favour of a minor too.

Operation of Special Classes of Deposit Account Holders

Minors' Accounts : Savings bank accounts can be opened by minors along with their guardians, and operated solely by the guardians, until the minor attains majority. Verification of signatures and other identification is repeated before the major (minor attaining majority) starts operating the account.

Account of illiterate/visually challenged persons: Accounts of illiterate/visually challenged individuals are usually opened by banks at their own discretion, in the presence of a mutually known witness. Terms and conditions of operating the account in this case are then specifically explained by the bank to the account-holder.

Operation of Accounts: Deposits by an account holder can be made with the use of pay-in-slip or credit slip while withdrawals can be made by withdrawal or debit slip or by cheque. Cheques can be used for payment to other parties also. Passbook is issued to the account holders and used as a record the transactions.

5.11 PAY-IN- SLIP

When the account holder or any one wants to deposit into an account can fill a pay-in-slip. This is also known as credit slip or deposit slip. The total amount of each note and coin is counted and entered on the slip, along with the name of the person who has paid it and the date. The cash and details are counted and checked by the teller at the bank, if everything is in order the deposit is credited to the account. The *pay-in-slip* is then kept by the bank and *pay-in-slip booklet* is stamped with the date and then returned to the account holder. An account holder uses their passbook to record their history of transactions with their bank.

SPECIMEN OF PAY-IN-SLIP

XYZ BANK
Guwahati Branch
Dist: Kamrup, Assam
Date:

Account Number									

Paid-in to the credit of ----------

Details of Cheque/Cash	Amount Rs
Cash/Cheque Deposit	
Total	

Rupees
……....
.....

XYZ BANK
Guwahati Branch
Dist: Kamrup, Assam 781001

Cash/Transfer

Date:

Account Number									

Paid in to the credit of……..…….……..

Details of Cheque/Cash overleaf	Amount Rs Ps
Cash/Cheque Deposit	
Total	

Rupees ……....
Mobile No:
PAN:

Signature of the Depositor

For Office Use		For Office Use	
SWO	CO	SWO	Cash Officer/Passing Officer

5.12 WITHRAWAL SLIP AND CHEQUE BOOK

Withdrawals normally require the account holder to visit the branch where the account is held, where a debit slip or withdrawal slip would be prepared and signed. The signature on the slip and the authorities would be checked against the signature record at the branch, before money is paid out. Withdrawal slips are similar to cheques in format but do not have any

serial number. Moreover, these are not negotiable. Withdrawal slips duly filled in are to be presented along with the pass book for payment in the bank. Withdrawals can be made through cheques also. A **cheque** is an unconditional order to the banker made by the depositor, to pay a specific amount to the payee on presentation of the said instrument. The account holder can issue a cheque in favour of someone to whom he wants to make a payment. A cheque is a negotiable instrument. The person who write the cheque, i.e. the customer or depositor is the drawer, the bank on which it is drawn, i.e. the bank to whom the order of payment is made is the drawee and the person to whom the cheque amount is payable is known as the payee. The 'drawer' may be the 'payee' also and in such case it is known as 'self cheque' or 'self drawn cheque'.

The depositor is provided with a book that contains several blank cheques. This book is known as cheque book**.** The blank cheques are serially numbered. The cheque book contains a requisition form also to make a fresh request for a new cheque book. The cheques can be used by the customer to withdraw money from his account or make a payment to any party. The blank cheque is to be filled up correctly with dates and duly signed by the account holder, and thereafter it becomes a valid cheque. In India, a cheque issued is valid for three months from the date of issue and can be presented in the bank for payment. After that the said cheque will not be a valid cheque and is known as 'stale cheque'. The specimen of a cheque is given below.

Banking transaction can be done through ATM cards and debit cards. Through these cards, cash can be withdrawn from the Automated Teller Machines. Transactions may take place through internet banking operation also. However, cash withdrawals are not possible through internet banking. Remittance or transfer from one account to another account is possible through internet mode of operation.

SPECIMEN OF A CHEQUE

XYZ BANK

Guwahati Branch

Dist: Kamrup, Assam 781001

D	D	M	M	Y	Y	Y	Y

Pay

……or bearer a sum Rupees…… Rs.

A/C No	xxxxxxx

Valid for Rs. 1,000,000 and under

IFSC CODE:XXXXXXXX

Signature

||088277|| 781002015 : 002601 || 31

5.13 PASS BOOK

A pass book or bank book is a paper book used to record bank transactions on a deposit account. Traditionally, a passbook is used for accounts with a low transaction volume, such as a savings account. A customer gets a passbook from the bank after opening an account. The customer has to present it with bank officials at the time of transactions or at periodical intervals to update the record. A bank would write the date and brief description of the transaction, amount of the debit or credit transaction, the updated balance. With the modernization of banks small dot matrix or inkjet printers were introduced to update the passbook at the account holder's convenience, either at an automated teller machine or a passbook printer, either in a self-serve mode, by post, or in a branch. The passbook states the name of the account holder, account number, type of account, mode of operation and any other relevant information. A specimen of the pass book is given below. Any transaction that increases the bank balance like deposits,

collection by bank on behalf of customers are credited while transaction that reduces the balance like withdrawals, transfer to others are debited.

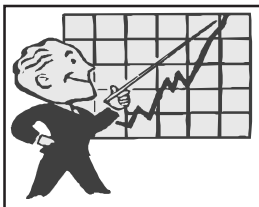
SPECIMEN OF PASS BOOK

XYZ Bank	
Saving Bank Account	Branch:
CIF No:	
Account No:	
Customer Name:	
S/D/W/H of:	
Address:	
Phone:	
Email:	
MOP:	
Nomination Reg. No:	
	Branch Manager

(First Page)

Date	Particulars	Cheque No	Debit	Credit	Balance	Initial

(Subsequent Pages for transaction record)



CHECK YOUR PROGRESS

Q 3: Which of the following can be used to with draw cash from a bank account?

A. Pay-in-slip

B. Debit Slip

C. Cheque

D. Both B and C

Q 4: A deposit is recorded on_____ column in a pass book.

A. Debit

B. Credit

Q 5: "A bank account can be opened in the name of a minor". This statement is:

A. True

B. False

Q 6: "Cash can be withdrawn through internet banking operation." This statement is:

A. True

B. False



5.14 LET US SUM UP

In this unit we have discuss the following:

- The basic function of a commercial bank is to accept bank deposits which are withdrwable on demand and use of those funds by lending to various user groups.
- Deposit account may be broadly classified into three types viz. (i) fixed deposit account, (ii) savings deposit account, and (iii) account. Fixed deposits are for a fixed tenure.
- Current accounts are meant for business houses where unlimited numbers of withdrawals are allowed. Usually, interest is not offered on current accounts.

- A person desiring to open a bank account can apply for the same in prescribed format available with the banks. After filling up the form, this may be submitted to the bank with necessary documents with regard to identity proof, address proof etc and photographs. On verification, bank may open account in the name of applicant.
- Accounts can be opened in single or joint form; for individuals or partnership firms or companies or institutions. Bank takes safety measures with regard to opening of accounts in the name of a minor, blind person and illiterate persons.
- Accounts can be operated through pay-in-slip, withdrawal slip and cheque book. ATM cards, internet banking are also other modes of operating bank account. The pass book is issued to the account holder where the transactions are to be recorded.



5.15 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.

5.16 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: C

Ans to Q No 2: C

Ans to Q No 3: D

Ans to Q No 4: B

Ans to Q No 5: A

Ans to Q No 6: B.



5.17 MODEL QUESTIONS

A. Short Type Questions:

Q 1: State the different types of deposit accounts.

Q 2: Mention the features of current deposit account.

Q 3: What is a pay-in-slip?

Q 4: What is a cheque?

Q 5: What information is recorded in a pass book?

B. Long Type Questions:

Q 1: Describe the various types of deposit accounts made in a bank.

Q 2: Explain the procedure of opening a savings bank account in a bank.

Q 3: What are the various forms used in banking operation? Give specimens of those forms also.

*** ***** ***

UNIT 6: DIFFERENT TYPES OF BANK CUSTOMERS

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning of Bank Customer

6.4 Different Types of Bank Customers

- 6.4.1 Individuals
- 6.4.2 Minor
- 6.4.3 Married Women
- 6.4.4 Pardanashin Woman
- 6.4.5 Lunatic
- 6.4.6 Illiterate Person
- 6.4.7 Joint Account
- 6.4.8 Hindu Undivided Family (HUF)
- 6.4.9 Partnership Firm
- 6.4.10 Accounts of a Registered Society, Club, Schools and other Non-Trading Institutions

6.5 Let Us Sum Up

6.6 Further Reading

6.7 Answers To Check Your Progress

6.8 Model Questions

6.1 LEARNING OBJECTIVES

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

- explain the meaning of bank customer
- describe the procedure of opening bank account in the name of a minor
- explain the procedure of opening bank account in the name of married women, pardanastin women, lunatic and illiterate person
- explain the procedure of operating joint account and the account of Hindu Undivided Family and partnership firm

- describe the procedure of opening and operating the accounts of registered society, club, schools and other non-trading institutions.

6.2 INTRODUCTION

In unit five we have discussed about different types of bank account. We all know that people open account with the bank for safe keeping of his/her money. Any individual or organization can open a bank account according to their needs. Any person or organization that has a bank account he/she is a customer for that particular bank. Bank classifies their customers depending upon their characteristics.

In this unit we will discuss about different types of customers and procedures of opening bank account in their name.

6.3 MEANING OF BANK CUSTOMER

The term customer has not defined under the law. Different views are being expressed in different times. In simple words a bank customer is anyone who conducts a banking transaction with a bank. He could be an individual, a group, a company, a trust, a firm, an institution.

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."

6.4 DIFFERENT TYPES OF BANK CUSTOMERS

6.4.1 Individuals

Every person who is competent to enter into a contract can open a bank account provided the bank is satisfied with the person and willing to do necessary business with that person. While opening an account in the name of an individual the banker must ensure that the account is opened with cash and not with a cheque or draft payable by some other bank or branch.

In case the customer wants his account to be operated by another person, a mandate to that effect must be submitted to the

bank along with the specimen signature of the agent who will operate the account. If the customer allows his agent to overdraw his account, the mandate should clearly state that.

There are certain persons such as minor, lunatic, pardanashin women etc. whose capacity to enter in to contract is subject to certain legal restrictions. However, bank can open accounts in their names after following certain procedures. In the following paragraphs we will discuss about such customers.

6.4.2 Minor

A minor is a person who has not completed his 18th year of age. Legally a minor is incapable to enter in to a contract but a bank account can be opened in the name of a minor. Since an agreement entered with a minor is void, banks have to be very cautious while entering in to any business relations with a minor. If the Court appoints a gurdian then the minor become major on completion of 21 years of his/her age. A banker should take the following precautions while dealing with a minor:

Opening of Account : It is preferable for a bank not to open a current account in the name of a minor. Because, in case of overdraft a minor cannot be held liable since minor has no personal liability. A savings bank account of a minor can be opened in any one of the following modes.

i) By a natural guardian, i.e., father or mother on behalf of the minor,

ii) By a natural guardian, i.e., father or mother in the joint names of himself/herself and the minor, payable to either or survivor;

iii) By a person in the name of any minor of whom he or she is the guardian appointed by a competent Court under any enactment for the time being in force;

iv) By a minor of age 10 and above in his/her single name to be operated upon by himself/ herself, provided he/she can put uniform signatures.

For opening a bank account in the name of a minor the bank requires the date of birth to be ascertained and verified from the Municipal Birth Certificate or Birth Certificate issued by the school authority where the minor is studying. The bank also requires recording the date of birth and date of maturity in the account opening form, specimen signature card, the ledger folio and the passbook.

A minor's account cannot be opened jointly by two minors. If the guardian dies before the minor attain majority then balance can be paid to minor after majority or to the natural guardian if survived. If the minor accountholder dies, the balance can be paid to the natural guardian and she/ he becomes the absolute owner of it.

Guardian

Guardian of a minor can be of following types:

Natural guardian: According to Sec.6 of Guardians and Wards Act, 1890, father is the natural guardian of a Hindu minor boy or unmarried girl and after death of him; mother shall become natural guardian, In the case of a married girl the husband is the natural guardian. Natural guardian does not include stepmother or stepfather.

Testamentary guardian: Testamentary guardian is a person appointed by a deed or will by a father to act as guardian of his one or more minor child.

Guardian appointed by the court: Under Guardians and Wards Act, 1890, the court can appoint a guardian for minor. However, the court is not authorized to appoint a guardian for a minor if his/her father/husband is alive, unless the court is of the opinion that such father/husband is unfit to be guardian of the minor.



CHECK YOUR PROGRESS

Q 1: Who is a minor?

.....

.....

Q 2: Can a minor open bank account?

.....

.....

6.4.3 Married Women

A married woman does not suffer from any incapacity to enter in to a contract except that only her personal estate can be held responsible for the contract made by her. Section 14 of the Hindu Succession Act, 1956 provides that property of a Hindu female shall be her absolute property. A married woman has a legal entity of her own, which is separate from her husband. According to the Hindu Marriage Act, 1956, Hindu married women can have separate property in her own name. A married woman can open accounts in her own name, operate freely and enjoy overdraft limit as long as the liabilities are met out from her own property. She cannot make her husband liable for any transaction or debt of her unless:

- she borrows money for the necessities of her life,
- she borrows for the necessaries of her household,
- she acts as agent of her husband.



CHECK YOUR PROGRESS

Q 3: Can a married woman makes her husband liable for her debt?

.....

.....

6.4.4 Pardanashin Woman

A Pardanashin woman is one who by the custom of a particular community to which she belongs, is obliged to puts a veil and does not show her face to people/outsiders. Such woman observes complete seclusion and even they do not pose for photographs. So it is very risky for a bank to enter in to any contract with a pardanashin women. Banks generally refuse to open accounts in the name of pardanasheen women, because identity of pardanasheen women cannot be ascertained as she observes

complete seclusion. However, if under special circumstances, such an account is opened, two respectable persons known to the branch invariably attest the signatures on the account opening form and on the withdrawal slips.

6.4.5 Lunatic

According to the provisions of Indian Contract Act, a person of unsound mind is not capable of entering in to a valid contract. Therefore, no banks knowingly open an account in the name of a person of unsound mind. A person may become lunatic after opening a bank account. In such a case, as soon as the bank receives the information all operations on the account of the customer is suspended till proof of customer's sanity is received. An account in the name of a lunatic person can be opened or operated only by a guardian appointed by a competent Court and the balance of such account is paid to the person appointed by the competent court.

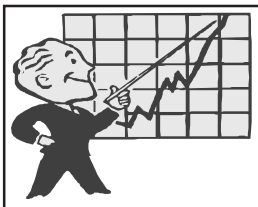
6.4.6 Illiterate Person

For a bank a person who is unable to sign is illiterate. Illiteracy does not make a person incapable to contract. Therefore, there is no restriction in opening and operating a bank account by an illiterate person. Implication and conditions of operation of the account should be explained to the accountholder by an authorized official. Withdrawals from the account should generally be allowed only when the person comes personally and produce his/ her pass book. However, banks do not open current account of illiterate person. The banker should take the following steps while opening an account of an illiterate person:

Thumb impression: The banker should obtain left hand thumb impression of the customer on the account opening form and the specimen signature sheet in the presence of an authorized supervising officer.

Identification Mark: Where possible, the banker should note one or two identification marks in the accounts opening form and the specimen signature sheet.

Photographs: The banker should obtain two copies of passport photographs of the accountholder and got renewed in every three years. One copy of which is to be pasted on the account opening form and another on the specimen signature sheet.



CHECK YOUR PROGRESS

Q 4: Should a banker open a current account in the name of an illiterate person?

.....

.....

6.4.7 Joint Account

Joint account is an account opened by two or more persons. For opening a joint account the account opening form should be signed by all the accountholders. The bank should obtain specific instruction as to whether one or more of the joint accountholders shall operate the account. In absence of such direction the banker should honour only those cheques which are signed by all the accountholders. A joint accountholder cannot delegate his authority to operate the bank account. A joint account can be operated in any one of the following mode:

(a) either or survivor

(b) both jointly

(c) former or survivor

If any change is required in operational instructions by any of them then signature of all the accountholders are required. However, any one of the accountholder can stop payment of a cheque issued by any other joint account holder.

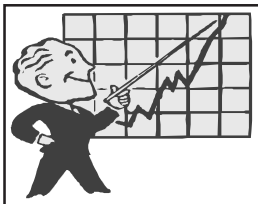
In case of death of one or more joint accountholders, the balance in the account will vest with the survivors. In case of death of all the joint accountholders, any balance in the account is payable to the legal representative of the joint accountholder who dies last, provided that no instruction to the contrary is given. In case a joint accountholder dies while the account is showing a debit balance, her/his legal representative jointly with the surviving joint accountholders remain liable for the debt.

6.4.8 Hindu Undivided Family (HUF)

The Hindu Succession Act 1956 governs HUF. The HUF carries out ancestral business and possesses ancestral properties. The eldest male member is called Karta and all other male members are called as coparceners. The right to manage HUF property vests in the 'Karta' of the family. Karta is either the father or the senior most male member of the family.

Operation of Account

- When an account is opened in the name of a HUF, all the adult members of the family need to sign and on behalf of all the family members the Karta operates the account.
- Banks do not open savings bank account of HUF engaged in trading and business activities.
- The bank should keep in record the names of male minor coparceners and their guardian must sign the documents on their behalf.
- In the name of the account and cheque issued use of the word HUF is essential along with the name of the unit.



CHECK YOUR PROGRESS

Q 5: Who operates the bank account of a HUF?

.....

.....

6.4.9 Partnership Firm

Section 4 of the Indian Partnership Act, 1932 defines partnership as a relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Registration of partnership firm is not mandatory except in Gujarat and Maharashtra.

Opening and Operation of Account

- Banker should open an account in the name of a partnership firm only when one or more authorized partner make an application for opening an account.
- Banker should ask for a letter signed by all the partners, stating the nature of business, name and address of all the partners along with operative instructions as to who will operate the account.
- Any partner may by notice in writing to the banker, revoke the authority given to any other partner regarding operating the firms account. Similarly any partner can stop the payment of a cheque already issued and the banker is bound to honour such instructions.
- A partner authorised to operate the firm's account cannot delegate his authority to another person unless all other partners agree. The authority given to operate the account can be withdrawn by any of the other partners including dormant or sleeping partner by giving notice to the bank.
- In case of a trading partnership firm every active partner has implied power to (a) borrow money for the purpose of the firm,(b) pledge the goods of the firm for borrowings,(c) draw, accept or endorse bills of exchange and other negotiable instruments.
- Death of a partner dissolves the partnership. However, for the purpose of winding up of the firm, the bank may allow the surviving partner(s) to operate the firm's account, if the account has credit balance.

Who can operate the Account?

- All partners jointly
- One of the named partners
- Two / three of the named partners
- A third party under a mandate letter or a power of attorney signed by all the partners.

6.4.10 Accounts of a Registered Society, Club, Schools and other Non-Trading Institutions

A society or any institution such as clubs, schools, hospitals etc are eligible to open an account with the bank. The banker should take the following precautions while opening an account for such organizations:

- **Society must be incorporated:** A club or a society gets legal entity only when it is registered under Companies Act, 1956 or under Cooperative Societies Act, 1860 . In absence of such registration the society will have no legal existence and will not be able to enter in to any contract. Hence, banker will refuse to open an account.
- **Copies of documents must be obtained:** While opening an account banks obtain a Copy of the byelaws; Copy of resolution passed by the managing committee regarding opening and conduct of account, Certificate of registration in original, a list of the Managing Committee members, Copies of resolutions electing them as Committee members duly certified by the Chairman.

  The resolution should contain the names of the persons who are entitled to operate the account on behalf of the society.
- **Borrowings:** A non trading organization has no implied power to borrow. Such organization can borrow only if the memorandum gives the power of borrow. So, before granting loan the banker should see the memorandum and the article of the society.



6.5 LET US SUM UP

In this unit we have discuss the following:

- Any person or organization that has a bank account he/she is a customer for that particular bank.
- An agreement entered with a minor is void; banks have to be very cautious while entering into any business relations with a minor.
- Banks generally refuse to open accounts in the name of Pardanasheen Women, because identity of Pardanasheen Women cannot be ascertained as she observes complete seclusion.
- When an account is opened in the name of a HUF, all the adult members of the family need to sign and on behalf of all the family members the Karta operates the account.
- A partner authorized to operate the firm's account cannot delegate his authority to another partner unless all other partners agree.



6.6 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.



6.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A minor is a person who has not completed his/her 18th year of age.

Ans to Q No 2: Yes, a minor can open a bank account.

Ans to Q No 3: No**,** a married woman cannot make her husband liable for her debt.

Ans to Q No 4: A banker should not open current account in the name of an illiterate person

Ans to Q No 5: Karta operates the bank account of a HUF.

6.8 MODEL QUESTIONS



Q 1: Who is a bank customer?

Q 2: What are the points to be kept in mind by a banker while opening an account in the name of a minor?

Q 3: What are the points to be considered by a banker while opening an account in the name of a partnership firm?

Q 4: How a joint account is operated?

Q 5: Who are the different types of guardian of a minor?

*** ***** ***

UNIT 7 : CREDIT CREATION BY COMMERCIAL BANKS

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Types of Deposits and Accounts

7.4 Methods of Credit Creation

7.5 Mechanism of Credit Creation

7.6 Limitations of Credit Creation

7.7 Let Us Sum Up

7.8 Further Reading

7.9 Answers To Check Your Progress

7.10 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- explain the various types of bank accounts
- explain the process of credit creation
- explain the mechanism of credit creation
- discuss about the various limitations of credit creation.

7.2 INTRODUCTION

Money and banking are part of everyday life. Banks offer all sorts of financial products to help us to manage our money on a day-to-day basis. The bank is such a place where once we deposit money, it remains safe and also earns interest over some time. This is known as the deposit and to each deposit, the bank assigns a unique identity which is known as the account.

Sometimes we use numbers to identify an account uniquely. This is what we call the account number. It may also be a combination of alphanumeric letters. Bank deposits serve different purposes for different

people. Some people cannot save regularly. They deposit money in the bank only when they have extra income. The purpose of deposit then is to keep money safe for future needs. Some may want to deposit money in a bank for as long as possible to earn interest or to accumulate savings with interest so as to buy a flat, or to meet hospital expenses in old age, etc. Some, mostly businessmen, deposit all their income from sales in a bank account and pay all business expenses out of the deposits.Banks not only keep deposit but also lend money and thereby create credit.

In this unit we will discuss the process of credit creation by commercial banks.

7.3 TYPES OF DEPOSITS AND ACCOUNTS

On the basis of purpose they serve, bank deposit accounts may be classified as follows:

Savings Bank Account

As the name suggests this type of account is suitable for people who have a definite income and are looking to save money. This type of account can be opened with a minimum initial deposit that varies from bank to bank. Money can be deposited at any time in this account. Withdrawals can be made either by signing a withdrawal form or by issuing a cheque or by using an ATM card. Normally banks put some restriction on the number of withdrawal from this account. Interest is allowed on the balance of deposit in the account. The rate of interest on savings bank account varies from bank to bank and also changes from time to time. A minimum balance has to be maintained in the account as prescribed by the bank.

Current Deposit Account

Big businessmen, companies, and institutions such as schools, colleges, and hospitals have to make payment through their bank accounts on regular basis and they also receive payment continuously. Since there are restrictions on the number of withdrawals from a savings bank account, that type of account is not suitable for them. They need to have an account from which withdrawals / deposits can be made any number of times.

Banks open a current account for them. Like a savings bank account, this account also requires a certain minimum amount of deposit while

opening the account. On this deposit, the bank does not pay any interest on the balances. Rather the account holder pays a certain amount each year as an operational charge.

For the convenience of the accountholders banks also allow withdrawal of amounts in excess of the balance in the account. This facility is known as overdraft facility. It is allowed to some specific customers and up to a certain limit subject to previous agreement with the bank. No limits for deposits and withdrawals are fixed in this type of account.

Fixed Deposit Account

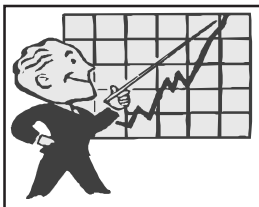
Some bank customers may like to put away money for a longer time. Such deposits offer a higher interest rate. If money is deposited in a savings bank account, banks allow a lower rate of interest. Therefore, money is deposited in a fixed deposit account to earn interest at a higher rate.

This type of deposit account allows the depositor to deposit a specific amount of money for a specified period of time. This period of deposit may range from 15 days to three years or more during which no withdrawal is allowed. However, on request, the depositor can encash the amount before its maturity. In that case, banks give lower interest than what was agreed upon. The interest on a fixed deposit account can be withdrawn at certain intervals of time. At the end of the period, the deposit may be withdrawn or renewed for a further period. Banks also grant a loan on the security of the fixed deposit receipt.

Recurring Deposit Account

While opening the account a person has to agree to deposit a fixed amount once regularly in a month like an instalment basis for a certain period. The total deposit along with the interest therein is payable on maturity. However, the depositor can also be allowed to close the account before its maturity and get back the money along with the interest till that period.

The account can be opened by a person individually, or jointly with another, or by the guardian in the name of a minor. The rate of interest allowed on the deposits is higher than that on a savings bank deposit but lower than the rate allowed on a fixed deposit for the same period.



CHECK YOUR PROGRESS

Q 1: What is recurring deposit account?

.....

.....

Q 2: What is current deposit account?

.....

.....

7.4 METHODS OF CREDIT CREATION

The following points highlight the two methods of creating credits through deposits. These methods are:

1. Primary or Passive Deposits:

The banks create passive deposits when they open deposit accounts in the name of those customers who bring cash or cheques to be credited to their accounts. The banks make loans and advances to their customers out of these deposits. But these primary or passive deposits do not make any net addition to the money which is in the circulation, these deposits merely convert currency money into deposit money. Therefore, creation of these primary or passive deposits does not mean creation of money, but these primary deposits provide funds out of which the bank makes loans and advances to the customers.

The bank knows that all these primary deposits are not going to be withdrawn by the depositors at the same time or one time. Only a small portion of these deposits may be withdrawn by the depositors depending upon their need at any one particular time, so the bank after keeping a small percentage of these deposits in cash, uses the remaining balances for making loans and advances to the customers.

In this connection, the normal norm of a commercial bank is that it keeps in reserve only 10% of its deposit to meet the demand of customers and invests 90% in giving loans and advances, it means it utilizes 90% in credit creation.

2. Derivative or Active Deposits:

Derivative or active deposits are created by the bank by opening a deposit account in the name of the person concerned who contacts bank to borrow money. Then the bank plays an active role in the creation of such deposits. This type of dealings is known as an active deposits or derivative deposits.

For example, Suppose, the bank allows a loan of Rs. 2,00,000 to its customer against any collateral security. What the bank will do is that it will open an account in the name of the person who has been granted loan. The bank will credit Rs. 2, 00,000 in it. The bank will not pay Rs. 2,00,000 in cash to the borrower.

The borrower may either withdraw from his account the entire amount immediately or he may withdraw small amount of money time to time according to his need and to his requirements and the balance amounts are granted as loans to other persons who require it. Here, it shall be noted that by making a loan, the bank, at the same time created a new deposit in its book.

Further, the active deposits are also created by the bank when it purchases securities or other forms of assets from the public or from government. For example-when the bank buys government securities or debentures of private firms, it makes the payment to the sellers of these assets by opening a deposit account in their names. The bank may also create deposits when it purchases bills of exchange by opening a deposit account in the name of the seller. All these kinds of transactions are done through active deposits or derivative deposits.



CHECK YOUR PROGRESS

Q 3: What is derivative deposit ?

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Q 4: What is passive deposit?

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7.5 MECHANISM OF CREDIT CREATION

While dealing with the different historical aspects of banking, we came to know how the early gold smiths of England conceived the idea of making profit by lending, on interest,with a safe amount out of the money deposited with them by their owners for safe custody.

They observed that only a certain fraction of the total amount of deposits needed to be kept with them in reserve to see that they did not fail any depositor when the latter claimed his money back. The rest of the money (gold, silver and other valuables) could be used profitably by others, which would bring in sizeable interest income to the gold smith bankers.

But what margin of the total deposit ought to be kept in reserve as ready cash, and what precautions had to be taken by the bankers to see that the loan-taker would not fail, etc., were left to the banker's own discretion.

Gradually the institution of a Central Bank came into existence, and the various regulations of the banks were made to strictly maintain a strict ratio between the total deposits they create (mostly credit deposits) and the cash in their possession.We shall be dealing with this minimum cash reserves in greater detail when we deal with the institution of Central Bank. We assume that all banks in our economy are obliged to keep the ratio between cash and its deposits data minimum of 20% (1/5).

We also assume that (i) the banks do not keep any excess reserves. In other words, it would exhaust all possible avenues of income earning activities like giving loans etc. up to the maximum extent after attaining the minimum cash reserve; (ii) there are no drains in the supply of money, i.e. the public do not suddenly want to hold more idle currency or withdraw from the time deposits.

Under the above assumptions, let us see what happens when a customer deposits a sum of Rs. 10,000 in a bank. The bank creates a deposit of Rs. 10,000 in his favour. A bank deposit (bank money) has increased by Rs. 10,000. But, at this stage, there is no increase in the total supply of money with the public, because the above extra bank money of Rs. 10,000 is offset by the cash of Rs. 10,000 deposited in the bank.

The bank has now additional cash of Rs. 10,000 in its custody. Since it is required to keep only a cash reserve of 20%, this means that Rs. 8000 is excess cash reserve with it. According to our assumption, the bank should lend out this Rs. 8000 to the public. Suppose, it does so, and the debtor deposits the money in his own account with another bank B, bank B is creating a deposit of Rs. 8000.

Bank B then has also excess cash reserve or Rs. 6400. It could, in its turn, lend out Rs. 6400 (80% of Rs. 8000). This Rs. 6400 will, in its turn, find its way with, say, bank C; it will create a deposit of Rs. 6400, and so on.

The total deposits will now grow into Rs. 10,000 + Rs. 8000 + Rs. 6400 +…. till ultimately the excess cash reserve reaches out. It can be shown that when that stage is reached the total of the above will be Rs. 50,000.

We will notice that the above was made possible because of the fact that a bank does not keep in its coffers cash equal to its deposit liability, but only a fraction of it; in the above illustration 20%.

It can be shown algebraically that if M represents total supply of money, AM represents increasing supply due to increase in bank deposits.

'R' represents the minimum cash reserve ratio expressed as a fraction.

△Crepresents the additional cash reserves initially injected into the system (Rs. 10,000 in the above illustration).

△M =△C/r

(In the above illustration r = 1/5 and AC = 10,000).

△M = 50000

This is the mechanism of multiple credit creation. The cash of Rs. 10,000 has now been converted into bank deposits of Rs. 50,000 of which Rs. 40,000 is credit money.

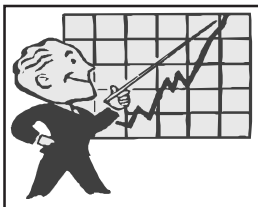
It should be care observed that the above mechanism works when there are several banks in the system, all of which follow the practices noted in our assumptions. However, there would not be much difference in the credit creation mechanism even if there were to be only a single bank.

In this type of situation, the secondary deposit of Rs. 8000 would have come back to the same bank. The bank would keep the necessary reserve and extend as loan the balance of the deposits. In this round again, the secondary deposit would come back to the bank; the process of credit creation would move as if it were a multi-bank economy.

7.6 LIMITATIONS OF CREDIT CREATION

1. **Cash Reserve Ratio:** The credit creation power of banks depends upon the amount of cash they possess with themselves. The larger the cash, the larger the amount of credit creation by banks. Thus, the bank's power of creating credit is limited by the cash it possesses.A higher CRR reduce the capacity of creating credit.
2. **Availability of Adequate and Proper Securities:** If proper securities or collateral securities are not available with the public, a bank cannot create credit. As Crowther has written-"the bank does not create money out of thin air, it transmutes other forms of wealth into money."
3. **Keeping of Reserve with the Central Bank:** Every affiliated and attached bank has to keep certain reserves with the central bank of the country. The central bank keeps on changing the percentages of these reserves from time to time. When the central bank increases the percentages of these reserves, then the power of the commercial banks to create credit is reduced in the same proportion. On the other-hand if the central bank reduces the percentage of these reserves, the power of the commercial banks to create credit is increased in the same proportion. Ultimately, credit creation capacity of commercial banks is fully dependent on its central bank.
4. **Banking Habits of the People:** The banking habits of the people are an important factor which governs the power of credit creation on the part of banks. If people are not in the habit of using cheques as substitute of cash , the grant of loans will lead to the withdrawal of cash from the credit creation stream of the banking system. This reduces the power of banks to create credit to the desired level because of low cash balances in bank accounts.

5. **Heavy Withdrawl of Cash by the Borrowers:** If the borrowers heavyly withdraw cash, then the balance of cash deposits will be disturbed. With the withdrawal of cash, the excess reserves of the banks are automatically reduced. This reduces the power of credit creation.
6. **Existence of Cash Transactions in the Economy:** This system of doing transaction sets another limitation on the power of the banks to create credit. In under-developed areas most of the transactions have to be effected in cash, rather than cheques or online banking transactions. This puts a question as to what extent banks power to create credit is reduced.
7. **Economic Conditions of Trade and Business:** The power to create credit by commercial banks depends upon the economic climate present in the country. If there are boom times, there is a greater scope of profitable investment and thus greater demand for bank loans on the part of businessmen. The banks will, therefore, be able to create a greater volume of credit at such a time. Similarly, during the period of depression the scope of profitable investment is limited for the businessmen. Hence, the investors will be less inclined to borrow from the banks. Therefore, the banks power to create credit will be automatically reduced.
8. **Maintain Statutory Liquidity Ratio:** The Commercial Banks under various banking laws are required to maintain a second line of defence in the form of the liquid assets. In India it has become essential to keep a percentage of the deposit in liquid forms by commercial banks. The liquid assets have been considered as government bonds and securities, treasury bills and other approved securities which can be en-cashed quite easily in emergency. Such SLR restrictions reduce the lendable resources with the banks and curtail their power to create credit to that extent.



CHECK YOUR PROGRESS

Q 5: State two limitations of credit creation.

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7.7 LET US SUM UP

In this unit we have discuss the following:

- The bank is such a place where once we deposit money, it remains safe and also earns interest over some time. This is known as the deposit and to each deposit, the bank assigns a unique identity which is known as the account.
- Savings deposit account can be opened with a minimum initial deposit that varies from bank to bank. Money can be deposited at any time in this account. Withdrawals can be made either by signing a withdrawal form or by issuing a cheque or by using an ATM card.
- While opening recurring deposit account a person has to agree to deposit a fixed amount once regularly in a month like an instalment basis for a certain period. The total deposit along with the interest therein is payable on maturity.
- The banks create passive deposits when they open deposit accounts in the name of those customers who bring cash or cheques to be credited to their accounts. The banks make loans and advances to their customers out of these deposits.
- Derivative or active deposits are created by the bank by opening a deposit account in the name of the person concerned who contacts bank to borrow money.
- Banks keep a certain fraction of the total amount of deposits with them in reserve to see that they did not fail any depositor when the latter claimed his money back. The rest of the money could be used profitably by others, which would bring in sizeable interest income to the bankers. This is called credit creation.



7.8 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.

2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.

3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.

4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.

5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.



7.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: While opening recurring deposit account a person has to agree to deposit a fixed amount once regularly in a month like an instalment basis for a certain period. The total deposit along with the interest therein is payable on maturity.

Ans to Q No 2: Big businessmen, companies, and institutions such as schools, colleges, and hospitals have to make payment through their bank accounts on regular and continuous basis. Banks open a current account for them. Like a savings bank account, this account also requires a certain minimum amount of deposit while opening the account. On this deposit, the bank does not pay any interest on the balances.

Ans to Q No 3: Derivative or active deposits are created by the bank by opening a deposit account in the name of the person concerned who contacts bank to borrow money. Then the bank plays an active role in the creation of such deposits.

Ans to Q No 4: The banks create passive deposits when they open deposit accounts in the name of those customers who bring cash or cheques to be credited to their accounts. The banks make loans and advances to their customers out of these deposits. But these primary or passive deposits do not make any net addition to the money which is in the vaults, these deposits merely convert currency money into deposit money.

Ans to Q No 5: Cash Reserve Ratio and Availability of Adequate and Proper Securities.

7.10 MODEL QUESTIONS



Q 1: What are the various types of bank accounts? Explain.

Q 2: What is credit creation? Discuss the limitations of credit creation

Q 3: Explain the mechanism of credit creation

Q 4: Discuss the various methods of credit creation

*** ***** ***

UNIT 8: CENTRAL BANKING IN INDIA

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning of Central Bank

8.4 Functions of a Central Bank

8.5 Reserve Bank of India

8.6 Central Banks of Different Countries

8.7 Let Us Sum Up

8.8 Further Reading

8.9 Answers To Check Your Progress

8.10 Model Questions

8.1 LEARNING OBJECTIVES

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

- explain the meaning of central bank
- describe the functions of a central bank
- explain the meaning and methods of credit control
- know about central banks of some countries.

8.2 INTRODUCTION

In the previous unit we have discussed about credit creation by commercial banks which deal with public and various other institutions. Since commercial banks and other financial institutions deals with public money there is a great need for monitoring and regulating such institutions. In present day situation almost every country in the world have such institutions which regulate and control the financial institutions and the monetary system as a whole. Such institutions are known as central bank. Presence of such institutions ensures safety of financial resources and brings confidence among the public and business houses.

In this unit we will discuss about various functions of central bank including the central bank of India i.e. Reserve Bank India.

8.3 MEANING OF CENTRAL BANK

In every economy there is a need for one apex institution to regulate, control and monitor the monetary system. A central bank is the apex institution of the monetary and banking system of a country. It controls and supervise the functioning of commercial banks operating in the country. It acts as the sole authority of issuing and regulating currency and credit in the economy.

Setting up of a central bank by every country is a 20th century phenomenon. *Sveriges Riksbank*, which is the central bank of Sweden, is the oldest central bank in the world established in the year 1668. The Bank of England, though established in the year 1694, started functioning as central bank only after passing The Bank of Charter Act in the year 1882. Other major countries of the world which established central bank in the 19th century are France in the year 1800, Netherlands in the year 1814, Russia in the year 1860, Germany in the year 1875 etc. The Federal Reserve System, which is the central bank of USA, was established in the year 1913 and the Reserve Bank of India which is central bank of India, was established in the year 1935. Thus, almost every nation of the world has got a central bank.

8.4 FUNCTIONS OF A CENTRAL BANK

We know that different countries have their own central bank. In the words of De Kock "guiding principle for a central bank whatever function or group of functions it performs at any particular moment is that it should act only in public interest and without regard to profit as a primary consideration." which means that the Central Bank of the country should act in the interest of public and just the profit should not be the main aim of the central bank. Though functions of central banks vary from country to country, it generally performs the following common functions:

- **Monopoly of note issue:** The central bank of every country has the absolute monopoly of issuing currency notes. The currency notes issued and circulated by the central bank are accepted as legal tender throughout the country. But, in some countries the monopoly of central bank to issue currency note is partial. For example, in India, one rupee notes are issued by the Ministry of Finance, Government of India and all other notes are issued by the Reserve Bank of India. The main advantages of giving monopoly power of note issue to the central banks are, a) it brings uniformity in the monetary system and, b) the central bank can exercise better control over the monetary system.

  For printing currency notes central banks of different countries follow different systems, such as partial fiduciary system, maximum fiduciary system, proportionate reserve system, minimum reserve system and foreign exchange system. In India, the RBI follows the minimum reserve system for issuing currency notes.

- **Banker, agent and advisor to the government:** The central bank acts as banker, agent and advisor to the government. As a banker to the government, central bank maintains accounts of the government; receive deposit from the government and makes short term advances to the government.

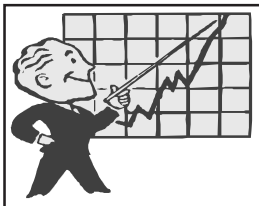
  As an agent to the government, central bank collect tax and other payments on behalf of the government. As a financial advisor to the government, the central bank gives advice to the government on financial, economic and monetary matters.

- **Bankers' bank:** The central bank acts as bankers of all the commercial banks of the country. Central bank acts as bankers' bank in three capacities, viz: (a) custodian of the cash reserve; (b) as the lender of the last resort; and (c) clearing agent. Mandatorily, all commercial banks need to keep a certain percentage of its cash balance as deposit with the central bank of the country. This deposit is called cash reserve.

- **Lender of the last resort:** As the bankers' bank the central bank acts as the lender of the last resort to the commercial banks. In case a commercial bank fails to meet their financial requirements from other

sources, the bank, as a last resort approach the central bank for financial accommodation. The central bank gives financial assistance to the commercial banks by rediscounting their eligible securities.

- **Clearing agent:** Since the Reserve Bank act as the custodian of cash reserve of commercial banks and all commercial banks maintain their accounts with the central bank, it becomes very easy for the central bank to settle the claims of various banks against each other with least use of cash.
- **Custodian of foreign exchange reserve:** The central bank act as custodian of foreign exchange reserve of a country. The central bank also manages exchange control and act as an agent of the government in international forums.
- **Controller of credit:** This is one of the most important function performed by a central bank. Credit control function of the central bank has direct influence on the economy of the country. Through this function the central bank control the volume of money in the economy. Efficient credit control establishes stability in the price level and exchange rate. Uncontrolled credit results in to fluctuation in the economy.
- **Other functions:** Besides performing above functions a central bank also perform some other functions such as conducting survey and seminars, formulation of monetary policy, development of banking system etc.



CHECK YOUR PROGRESS

Q 1: Mention three functions of a central bank

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Q 2: Name the oldest central bank of the world

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Q 3: Mention three quantitative methods of credit control.

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Q 4: Mention three Qualitative methods of credit control.

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8.5 RESERVE BANK OF INDIA

The origins of the Reserve Bank of India can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton-Young Commission – recommended the creation of a central bank for India to separate the control of currency and credit from the government and to augment banking facilities throughout the country.

The central office of the Reserve Bank was initially established in Calcutta but was permanently moved in Mumbai in the year 1937. The central office is where the governor sits and where the policies are formulated. RBI was established on April 1st1935 in accordance with the provisions of the Reserve Bank of India Act 1934. After the partitionof India the Reserve Bank had served as the Central Bank of Pakistan up to June 1948, when the State Bank of Pakistan commenced operation. The bank which was originally set up as a shareholders' bank was nationalized in the year 1949.

The RBI performs the functions the Central Bank as well as the departmental and the promotional function. The Reserve Bank designs and implements the regulatory policy framework for banking and non-banking financial institutions with the aim of providing people access to the banking system, protecting depositors' interest, and maintaining the overall health of the financial system. Since then the Reserve Bank's role and functions have undergone numerous changes, as the nature of the Indian economy has changed.

Organisational Structure of RBI

The organisational structure of the RBI is as under:

Central Board of Directors

Governor

Deputy Governors

Executive Directors

Principal Chief General Manager

Chief General Managers

General Managers

Deputy General Managers

Assistant General Managers

Managers

Assistant Managers

Support Staff

Central Board of Directors

The Central Board of Directors is at the top of the Reserve Bank's organisational structure. Appointed by the Government under the provisions of the Reserve Bank of India Act, 1934, the Central Board has the primary authority and responsibility for the oversight of the Reserve Bank. It delegates specific functions to the Local Boards and various committees. The Governor is the Reserve Bank's chief executive. The Governor supervises and directs the affairs and business of the RBI. The management team also includes Deputy Governors and Executive Directors.The Central Government nominates fourteen Directors on the Central Board, including one Director each from the four Local Boards. The other ten Directors represent different sectors of the economy, such as, agriculture, industry, trade, and professions. All these appointments are made for a period of four years. The Government also nominates one Government official as a Director representing the Government, who is usually the Finance Secretary to the Government of India and remains on the Board 'during the pleasure of the Central Government'. The Reserve Bank Governor and a maximum of four Deputy Governors are also ex officio Directors on the Central Board.

Local Boards

The Reserve Bank also has four Local Boards, constituted by the Central Government under the RBI Act, one each for the Western, Eastern,

Northern and Southern areas of the country, which are located in Mumbai, Kolkata, New Delhi and Chennai. Each of these boards has five members appointed by the central government for a term of four years. These boards represent territorial and economic interests of their respective areas, and advise the central board on matters, such as, issues relating to local cooperative and indigenous banks. They also perform other functions that the central board may delegate to them.

Offices and Branches

The Reserve Bank has a network of offices and branches through which it discharges its responsibilities. The units operating in the four metros — Mumbai, Kolkata, Delhi and Chennai — are known as offices, while the units located at other cities and towns are called branches. Currently, the Reserve Bank has its offices, including branches, at 27 locations in India. The offices and larger branches are headed by a senior officer in the rank of Chief General Manager, designated as Regional Director while smaller branches are headed by a senior officer in the rank of General Manager.

Central Office Departments

The work areas of the RBI are allocated among various departments. The changing role of the Reserve Bank necessitated closing down of some departments and creation of new departments. Currently, the Reserve Bank of India perform its functions through twenty-seven departments,located at the Bank's Central Office, Mumbai.They are headed by senior officers in the rank of Chief General Manager. The Departments are -

Markets

Department of External Investments and Operations

Financial Markets Department

Financial Stability Unit

Internal Debt Management Departmen

Monetary Policy Department

Regulation and Supervision

Department of Banking Operations and Development

Department of Banking Supervision

Department of Non-Banking Supervision

Foreign Exchange Department

Rural Planning and Credit Department

Urban Banks Department

Research

Department of Economic Analysis and Policy

Department of Statistics and Information Management

Services

Customer Service Department

Department of Currency Management

Department of Government and Bank Accounts

Department of Payment and Settlement Systems

Support

Department of Administration and Personnel Management

Department of Communication

Department of Expenditure and Budgetary Control

Department of Information Technology

Human Resources Development Department

Inspection Department

Legal Department

Premises Department

Rajbhasha Department

Secretary's Department

8.6 CENTRAL BANKS OF DIFFERENT COUNTRIES

In the beginning of the unit we have discussed that almost all countries of the world has their own central bank. In this part of the unit we will discuss about a few central banks of different countries specially our neighboring countries.

- **Reserve Bank of India:** The Reserve Bank of India (RBI) is India's Central Bank. It is the apex monetary institution which supervises, regulates controls and develops the monetary and financial system of the country. The Reserve Bank of India (RBI) Act, 1934 (II of 1934) provides the statutory basis of the functioning of the bank. The

preamble to the Reserve Bank of India Act, 1934, states that the main function of the bank as the central bank of the country is "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". Keeping in view this, the Reserve Bank of India was established as a "pure" Central bank which do not undertakes commercial banking function except in an emergency. The Act gives the monopoly of note issue, government's financial transactions, and credit control and also gives the power to control the foreign exchange reserve of the country.

- **Bangladesh Bank:** Bangladesh Bank is the central bank of Bangladesh. It is the apex regulatory body for the Bangladesh monetary and financial system. Bangladesh Bank was established as a body under Bangladesh Bank Order, 1972. The head office of Bangladesh Bank is located in Dhaka. Currently it has ten offices located in different parts of Bangladesh.
- **Royal Monetary Authority:** Royal Monetary Authority (RMA) is the central bank of Bhutan. Prior to the establishment of the RMA in 1982, central banking functions in Bhutan were conducted by three agencies viz., the Ministry of Finance, State Trading Corporation of Bhutan and Bank of Bhutan. The RMA started its functioning from 1st November, 1983 by taking over the liability of notes and coins previously issued by the Ministry of Finance. In 1988, the Authority assumed the role of government banker, holding bulk of government deposits and providing finance through ways and means advance to the Government. In the year 1992, The Royal Monetary Authority Act 1982 was amended to include licensing, regulation and supervision of financial institutions of Bhutan.

  After Bhutan made the momentous transition to a Democratic Constitutional Monarchy in 2008, the Royal Monetary Authority of Bhutan, Act, 1982 was amended and accordingly the Royal Monetary Authority Act of Bhutan 2010 was enacted by the Parliament of the Kingdom of Bhutan on June, 2010. With the historic enactment of the

Royal Monetary Authority Act of Bhutan 2010, and the appointment of Bhutan's first Central Bank Governor on August 18,2010, the status of the RMA has been elevated to that of an autonomous Central Bank with greater powers in terms of its mode of functioning and decision making process. It now performs all central banking functions that are generally performed by the central banks in other countries.

- **Nepal Rastra Bank (NRB):** Nepal Rastra Bank is the central bank of Nepal which was established in 1956 under Nepal Rastra Bank Act, 1955. Nepal Rastra Bank Act was amended by the Nepal Rastra Bank Act of 2002, and the functions and objective of NRB is recast.
- **The People's Bank of China (PBC):** The People's Bank of China is the central bank of China established in the year 1948. Between 1950 and 1978 the PBC was the only bank in the People's Republic of China and was responsible for both central banking and commercial banking operations. In September 1983, the State Council decided to have the PBC function as a central bank. The Law of the People's Republic of China on the People's Bank of China adopted on March 18, 1995 and central bank status was legally confirmed to the PBC's.
- **The State Bank of Pakistan:** The State Bank of Pakistan is the central bank of Pakistan. During the British Colonial period the Reserve Bank of India was the central bank for both India and Pakistan. On 30th December 1948 the British Government's commission distributed RBI's reserves between India and Pakistan in the ratio of 30:70. In May, 1948 Muhammad Ali Jinnah took steps to establish the State Bank of Pakistan immediately. These were implemented in June 1948, and the State Bank of Pakistan commenced operation on July 1, 1948. The headquarters are located in the financial capital of Pakistan, Karachi with its second headquarters in the capital, Islamabad.
- **Bank of Japan:** Bank of Japan is the central bank of Japan. The bank was established under The Bank of Japan Act, 1882 and started functioning as central bank from October, 1882. The bank was reorganized in the year 1942. The Act of 1942 was amended several times after World War II. Such amendments included the establishment

of the Policy Board as the Bank's highest decision-making body in June 1949.The Act of 1942 was revised completely in June 1997 under the two principles of "independence" and "transparency." The revised Act came into effect on April 1, 1998. The head office of the bank is located in Tokyo.

- **Bank of England:** Bank of England is the central bank of United Kingdom. Established in the year 1694, it happens to be the world's second oldest central bank. It was established to act as a banker to the British Government and still it continues to be the banker for the U.K. Government. Originally the bank was privately owned by stockholders until nationalized in the year 1946. It became an independent public organization in the year 1998, wholly owned by Treasury Solicitor on behalf of the government.
- **Federal Reserve System:** The Federal Reserve System or Federal Reserve is the central banking system of United States of America. It was created to provide the USA with a safer, more flexible, and more stable monetary and financial system. The Federal Reserve was created on December 23, 1913, when President Woodrow Wilson signed the Federal Reserve Act.



8.7 LET US SUM UP

In this unit we have discuss the following:

- Central bank is the apex institution in the monetary and banking structure of a country.
- Major functions performed by a central banks are issuing currency notes, banker to the government, bankers' bank, lender of the last resort, clearing agents etc.
- Through the function of credit control the central bank regulate the volume of money in the economy.
- Various credit control measures adopted by central bank are bank rate policy, open market operation, moral suasion, rationing of credit, issue of directive etc.



8.8 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.

2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.

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4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.

5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.



8.9 ANSWERS TO CHECK YOUR PROGRESS



Ans to Q No 1: Three functions performed by central banks are Banker, agent and advisor to the government, Monopoly of note issue and Bankers' bank.

Ans to Q No 2: *Sveriges Riksbank* is the oldest central bank in the world It is the central bank of Sweden.

Ans to Q No 3: Open market operation, Bank Rate Policy, Variation in the cash reserve ratio are the three quantitative methods of credit control.

Ans to Q No 4: Fixation of margin requirements, Rationing of credit, Regulation of consumer credit are the three qualitative methods of credit control.

8.10 MODEL QUESTIONS

Q 1: What are the functions of a central bank? Discuss

Q 2: What are the methods adopted by a central bank for controlling credit?

Q 3: Write a note on the central bank of Bhutan and Nepal.

*** ***** ***

UNIT 9 : CREDIT CONTROL

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Meaning of Credit Control

9.4 Methods of Credit Control

9.4.1 Quantitative or General Methods

9.4.2 Qualitative or Selective Methods

9.5 Objectives of Credit Control

9.6 Let Us Sum Up

9.7 Further Reading

9.8 Answers to Check Your Progress

9.9 Model Questions

9.1 LEARNING OBJECTIVES

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

- explain the meaning of credit control
- describe the methods of credit control
- explain the objectives of credit control.

9.2 INTRODUCTION

You might have come across some news about change in repo rate, cash reserve ratio (CRR), statutory liquidity ratio (SLR) etc. These are some of the instruments through which Reserve Bank of India control the volume of credit. There are some other measures also which are applied by the RBI for controlling credit.

In this unit we will discuss the objectives of credit control and various credit control techniques.

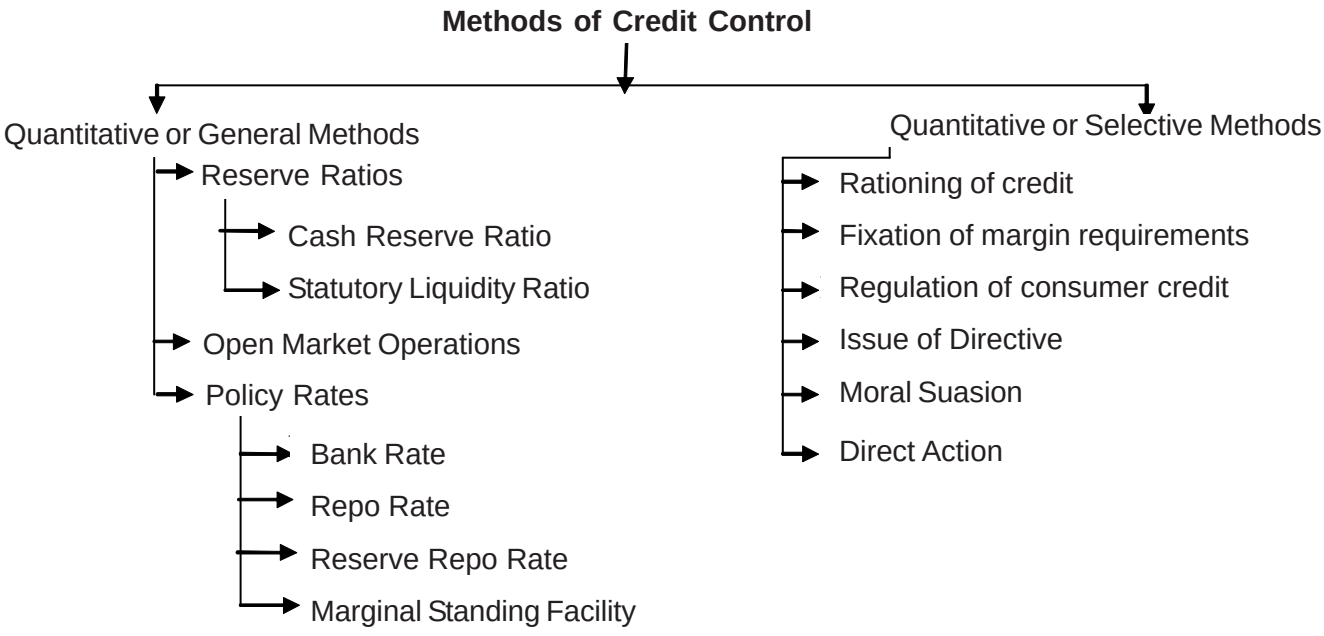
9.3 MEANING OF CREDIT CONTROL

Credit control is one of the most important functions of the Reserve

Bank of India. The Reserve Bank controls the credit in the country with the twin objectives of checking inflation and facilitating economic development. Credit Control means the regulation of the creation, contraction and the directions of credit in the economy. The importance of credit control has increased because of the growth of bank credit and other forms of credit. Commercial banks increase the total amount of money in circulation in the country through the mechanism of credit creation. In addition businessmen buy and sell goods and services on credit basis. Because of these developments, most countries of the world are based on credit economy rather than money economy.

9.4 METHODS OF CREDIT CONTROL

Credit control is one of the most important functions performed by the Reserve Bank of India. The Reserve Bank controls the credit in the country with the twin objectives of checking inflation and facilitating economic development. Credit control weapons used by the Reserve Bank may be either quantitative or qualitative. The Reserve Bank has been employing both types of weapons to control credit by virtue of powers given to it by the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.



9.4.1 Quantitative or General Methods of Credit Control

These are the traditional methods of credit control used by central bank. By using these methods central bank aims at regulating the volume of credit. Following are the various quantitative methods of credit control:

1. Reserve Ratios

(a) Cash Reserve Ratio (CRR): All commercial banks need to keep a certain percentage of its cash balance as deposit with the central banks. This deposit is known as cash reserve. This percentage of cash reserve is used by the central bank to regulate the volume of credit in the economy.

When the central bank wants to reduce volume of credit, it increases the rate of CRR to be kept by the commercial banks. This leads to reduce in the lending ability of commercial banks. On the other hand, when the central bank wants to increase the volume of credit, it resorts to reduction in the rate of CRR. This leads to increase in the lending ability of commercial banks. In this way central bank use CRR as a weapon of credit control.

(b) Statutory Liquidity Ratio: The statutory liquidity ratio refers to that proportion of aggregate deposits which the commercial banks are required to keep with themselves in a liquid form. The commercial banks generally make use of this money to purchase the government securities. Thus, the statutory liquidity ratio, on the one hand is used to siphon off the excess liquidity of the banking system, and on the other it is used to mobilise revenue for the government. The Reserve Bank of India is empowered to raise this ratio up to 40 per cent of aggregate deposits of commercial banks.

2. Open market operation: It refers to buying and selling of government securities by the central bank from money market. In countries where market for government securities is limited,

open market operation may include government guaranteed securities and municipal or other securities. In most of the countries, these operations are confined to the sales and purchases of government securities.

When the central bank wants to reduce the volume of credit, it sells eligible securities in the market. When commercial banks purchase these securities, they have to make payments to the central bank. This results in flow of cash from commercial banks to central bank. This has lead to fall in the primary reserve of the commercial banks. Hence, the capacity of the banks to expand credit will be reduced. This is followed during inflationary situation.

On the other hand, when the central bank wants to increase the volume of credit, it buys the approved securities from the open market. When central bank purchases securities, it needs to make payment to the commercial banks which result in flow of cash from central bank to the commercial banks. This has lead to increase in the volume of cash reserve in the hands of commercial banks. In such a situation, commercial banks find themselves in a position to expand credit. This is followed during deflationary situation.

3. Policy Rates

(a) Bank Rate Policy: The bank rate or discount rate is the rate at which a central bank is ready to rediscount the first class bill of exchange. In other words, the rate of interest which the central bank charges from commercial banks for rediscounting the bill is called bank rate. By changing bank rate central bank control the volume of credit. There is a direct link between bank rate and market interest rate. A change in the bank rate leads to change in the other interest rates prevailing in the market. An increase in the bank rate usually leads to the following events:

i) credit become more costly
ii) less supply of money
iii) discourage economic activity
iv) fall in price level.

Similarly, a fall in the bank rate leads to the following events:

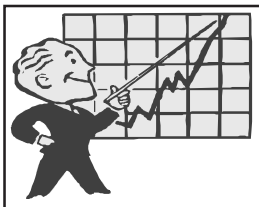
i) cheap credit
ii) increase in the volume of money supply
iii) encourage borrowings
iv) increase in the economic activities and price level

(b) Liquidity Adjustment Facility: Under this facility, RBI provides liquidity to schedule commercial banks and primary dealers or absorbs excess liquidity on an overnight basis against approved government securities.

The interest rate at which RBI provides liquidity to banks under liquidity adjustment facility is known as Repo Rate. The interest rate at which RBI absorbs excess liquidity of banks is known as Reverse Repo Rate.

Reduction in repo rate help banks to get money at a cheaper rate, while increase in repo rate make bank borrowings from central bank more expensive. If the central bank wants to make borrowings more expensive for the banks, it increases the repo rate. Similarly, if it wants to make borrowings cheaper for banks, it reduces the repo rate. So, an increase in the repo rate will reduce the supply of money and a decrease in the repo rate will increase the supply of money in the economy. The reduction in reverse repo rate has the opposite effect on credit creation.

(c) Marginal Standing Facility: Under this facility the commercial banks can borrow additional money from RBI on overnight basis up to a certain limit of statutory liquidity ratio at a penal interest rate. It is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely.



CHECK YOUR PROGRESS

Q 1: What is mean by credit control?

.....

.....

Q 2: What is repo rate?

.....

.....

9.4.2 Qualitative or Selective Methods of Credit Control

The qualitative credit control methods are used as an addition to general credit control. In certain situations quantitative credit control may not be helpful.

The selective credit control methods control certain types of credit and not all credit. They directly affect the demand for bank credit as also the capacity of the banks to lend. They can be used more effectively without any changes in the prevailing rates of interest. Under these methods the credit is made available for the productive and priority sectors and restricted to others. This is very much helpful to the developing and underdeveloped economies. In the following paragraphs we will discuss about various instrument of qualitative credit control:

(a) Rationing of credit: Through this method the central bank controls the credit created by the banks. Under this method, the central bank fixes the limit for loans that a bank can extend to a particular sector for all purposes. However, credit rationing is not used as an instrument of credit control under normal circumstances. It is used only under exceptional circumstances.

(b) Fixation of margin requirements: Margin requirement is the difference between the market value of the security and its maximum loan value against the security. If a security has a market value of Rs 1000 and the central bank prescribe a

margin of 60% the bank can advance only Rs 400 against that security. The central bank prescribes the margin limit which banks and other lenders must maintain while granting loan against security.

An increase in the margin requirement by the central bank leads to decrease in the amount of credit to the borrowers and a decrease in the margin requirement by the central bank leads to increase in the amount of credit to the borrowers.

(c) Regulation of consumer credit: In consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash and the balance is financed through bank credit which is repayable by the consumer to the bank in installments. Central bank regulate consumer credit by:

(i) changing the amount that can be borrowed for purchase of consumer durable,

(ii) fixing the amount of down payment and,

(iii) changing the length of the period over which installment may be spared.

(d) Issue of Directive: Central bank may issue directive from time to time to control the volume of credit created by banks. This directive may be in the form of written orders, warnings and appeals. Central bank issue directive to the commercial banks for the following purpose:

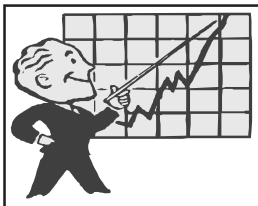
(i) to divert the flow of credit for productive purposes

(ii) to fix the maximum credit limit for certain purposes

(iii) to control the lending policies of commercial banks

(e) Moral Suasion: Moral suasion means advice, suggestions and persuasions to the commercial banks to cooperate the central bank in implementing general monetary policy. For example, the central bank may request the commercial banks not to grant loan for illegal or speculative purpose. If commercial banks donot follow such advice no panel action is taken against them.

(f) Direct Action: This is one of the most effective weapons of controlling credit creation. This refers to the directions issued by the central bank to the commercial banks regarding their lending and investment policies. The central bank uses this method to supplement both quantitative and qualitative methods of credit control.



CHECK YOUR PROGRESS

Q 3: Mention three quantitative methods of credit control.

.....

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Q 4: Mention three Qualitative methods of credit control.

.....

.....

9.5 OBJECTIVES OF CREDIT CONTROL

The central bank is usually given many weapons to control the volume of credit in the country. The uses of these weapons are guided by the following objectives.

(i) Stability of Internal Price-Level : The commercial bank can create credit because their main task is borrowing and lending. They creates credit without any increase in cash with them. This leads to increase in the purchasing power of many people which may lead to an increase in the prices. The central bank applies its credit control techniques to bring about a proper adjustment between the supply of credit and measures required to that effect in the country concerned. This helps in keeping the prices stable under control.

(ii) Checking Booms and Depressions : The operation of trade cycles causes instability in the country, so the objective of the credit control should be to reduce the uncertainties caused by these cycles. The central bank adjusts the operation of the trade cycles by increasing and decreasing the volume of credit.

(iii) **Promotion of Economic Growth :** The objective of credit control policy in backward and underdeveloped countries should be to promote economic growth within the shortest possible time. Generally speaking, the economic development in these countries is retarded on account of lack of financial resources. Hence, the central banks in these countries often try to solve the problems of financial stringency through planned expansion of bank credit.

(iv) **To Regulate and Expand Banking :** RBI regulates the banking system of the economy. RBI has expanded banking to all parts of country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks. All this has expanded banking in all parts of country.

(v) **Stabilisation of the Money Market :** According to some economists the credit control policy of the central bank should aim at the stabilisation of the money market in the country. To achieve this objective, the central bank should neutralize seasonal variations in the demand for funds. It should for example, provide extra credit in times of emergencies. In fact, the control on credit should be exercised by the central bank in such a manner as to bring about an equilibrium in the demand and supply of money at all times.

(vi) **Stability in Exchange Rates :** This is also an important objective of credit control. Credit control measures certainly influence the price level in the country. The internal price level affects the volume of exports and imports of the county which may bring fluctuations in the foreign exchange rates. While using any measure of credit control, it should be ensured that there will be no violent fluctuation in the exchange rates.

(vii) **Preparation for war and other Emergencies :** Sometimes the objective of the central bank is to prepare the country for war through expansion of credit to enable the government to meet its financial requirement. Modem v/ars are so expensive that it is not possible to meet their costs without adequate expansion of bank credit. During

the Second World War almost every country resorted to expansion of credit on a large scale to meet the rising war expenditure



9.6 LET US SUM UP

In this unit we have discuss the following:

- Central bank is the apex institution in the monetary and banking structure of a country.
- Major functions performed by a central banks are issuing currency notes, banker to the government, bankers' bank, lender of the last resort, clearing agents etc.
- Through the function of credit control the central bank regulate the volume of money in the economy.
- Various credit control measures adopted by central bank are bank rate policy, open market operation, moral suasion, rationing of credit, issue of directive etc.



9.7 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.

9.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Credit Control means the regulation of the creation, contraction and the directions of credit in the economy.

Ans to Q No 2: The interest rate at which RBI provides liquidity to banks under liquidity adjustment facility is known as Repo Rate.

Ans to Q No 3: Open market operation, Bank Rate Policy, Variation in the cash reserve ratio are the three quantitative methods of credit control.

Ans to Q No 4: Fixation of margin requirements, Rationing of credit, Regulation of consumer credit are the three qualitative methods of credit control.



9.9 MODEL QUESTIONS

Q 1: Mention the objectives of credit control.

Q 2: Discus the methods adopted by a central bank for controlling credit?

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UNIT 10 : BANKING LEGISLATIONS IN INDIA

UNIT STRUCTURE

10.1 Learning Objective

10.2 Introduction

10.3 Banking Regulation Act, 1949

- 10.3.1 Objects of Banking Regulation Act, 1949
- 10.3.2 Extent and applicability of the Banking Regulation Act:
- 10.3.3 General Provisions

10.4 Requirements as to Minimum Paid-up Capital and Reserves

10.5 Constituents of Board of Directors

10.6 Licensing of Banking Companies

10.7 Accounts and Audit

10.8 Powers of the RBI

10.9 Deposit Insurance in India

10.10 Let Us Sum Up

10.11 Further Reading

10.12 Answers To Check Your Progress

10.13 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- know the objectives of Banking Regulation Act, 1949
- discuss the important provisions of the Banking Regulation Act, 1949
- understand the government's and RBI's power to control and regulate banks.

10.2 INTRODUCTION

Banks are public service institutions dealing with the funds of the public. Unlike joint stock companies which obtain the required capital from the shareholders, banks obtain a very large proportion of their working capital from the public in the form of deposits. Hence, in the national interests, there is a need to regulate the working of banks by a separate Act.

In the early stage of its existence in India, the banking industry did not have any separate law to regulate its activities and so banks were brought under the control of the Indian Companies Act. Though the Central Banking Enquiry Committee recommended the need for a separate legislation, it was not given due consideration then.

In this unit we will discuss some legal provisions related to Indian banking system.

10.3 BANKING REGULATION ACT, 1949

The Banking Companies Act, 1949 was passed to consolidate and amend the law relating to banking companies. The need for this was felt owing partly to the abuse of powers by persons controlling some banks and the absence of measures for safeguarding the interests of depositors, of banking companies in particular and partly to the economic interests of the country in general. This Act was renamed as the Banking Regulation Act from 1 March 1966.

The Banking Regulation Act is legislation in India that regulates all banking firms in India. The Act provides a framework under which commercial banking in India is supervised and regulated. The Act supplements the Companies Act 1956.The Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Important changes in several provisions of the Act were made from time to time with a view to enlarge or amplify the responsibilities of the RBI or to impart flexibility to the relative provisions, commensurate with the changing requirements of the banking sector.

10.3.1 Objects of Banking Regulation Act, 1949

The Banking Regulation Act provides a comprehensive definition of ‘banking’ and brings within the scope of legislation all institutions which undertake banking business. The main objects of the Act are stated below:

i. It prohibits non-banking companies from accepting deposits repayable on demand.

ii. It prohibits trading by banking companies to eliminate non-banking risks.

iii. It prescribes a minimum capital standards to prevent bank failures due to inadequacy of capital.

iv. It introduces a comprehensive system of licensing of banks and their branches in order to avoid indiscriminate opening of new branches and thereby ensuring balanced development of banking companies.

v. It includes in the scope of the legislation banks incorporated or registered outside India.

vi. It empowers the Central Government and the Reserve Bank of India to regulate and supervise the working of banking companies in India.

vii. It provides a quick and easy procedure for liquidation of banks.

10.3.2 Extent and applicability of the Banking Regulation Act

The Banking Regulation Act extends to the whole of India and is applicable to-

i. Private Sector Banks

ii. Public Sector Banks

iii. Co-operative Banks excluding-

a) Primary Agricultural Credit Societies;

b) Non-agricultural Primary Credit Societies with paid up capital and reserves of less than Rs.1lakh.

c) Cooperative Credit Societies where principal business is not banking but which accept deposits only from members and provide financial help only to them.

d) Cooperative Societies not carrying on banking business.

e) Land Mortgage Banks.

10.3.3 General Provisions

The general provisions of the Banking Regulation Act, 1949 are summarised below:

1. Forms of business in which the banking company may engage (Section 6)

A banking company may engage in the following forms of business in addition to the usual banking business:

a) Basic Business

i. Borrowing, raising or taking up of money

ii. Lending or advancing of money either upon or without security

iii. Drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts, bill of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not

iv. Granting and issuing of letters of credit, traveller's cheques and circular notes

v. Buying, and selling of foreign exchange including foreign bank notes

vi. Acquiring, holding, issuing on commission, underwriting and dealing in stocks, funds, shares, debentures, debenture stocks, bonds, obligations, securities and investments of all kinds

vii. Purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others; the negotiating of loan and advances.

viii. Receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise

ix. Providing of safe deposit vaults; the collecting and transmitting of money and securities

b) Agency Business

i. Acting as agents for any government or local authority or any other person or persons

ii. Carrying on of agency business of any description including the clearing and forwarding of goods,giving of receipts and discharges, etc.

iii. Contracting for public and private loans and negotiating and issuing the same

iv. Effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private of State, municipal or other loans or of shares,stock,debentures or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue.

v. Carrying on and transacting every kind of guarantee and indemnity business

vi. Managing, selling and realising any property which may come into the possession of the company in satisfaction and part satisfaction of any of its claims.

vii. Undertaking and executing trusts, etc.

2. Prohibition of Trading (Section 8)

A banking company cannot get in directly or indirectly contracts in buying or selling or exchange of goods.

3. Disposal of Non-Banking assets (Section 9)

Banks cannot hold any property for more than 7 years for the purpose of settlements of debts or obligations.Such time limit of 7 years can be augmented by the Reserve Bank of India for another 5 years,if it thinks appropriate.

4. Charge on Unpaid Capital(Section 14)

No banking company shall create any charge upon any unpaid capital of the company and any such charge shall be invalid, if created.

5. Payment of Dividend(Section 15)

A banking company cannot pay any dividend on its shares until all its capitalised expenses including preliminary expenses, organisation expenses, brokerage, etc. have been completely written off.

6. Reserve Fund (Section 17)

Every banking company must generate a reserve a fund out of its earnings after tax and interest. Such reserve amount should be at any rate 20 per cent of such profits. Exemption can be provided only if the cumulative amount of reserve fund and securities premium is greater than the paid up capital of the company.

7. Cash Reserve (Section 18)

At least 3 per cent of the total demand and time liabilities should be kept as reserve or should be secured in current account with Reserve Bank of India .Liabilities will not comprise money received from RBI/EXIM bank/Development bank or any such other bank. Such amount should be deposited/kept on last Friday of every 2nd fortnight of every month. The return should be deposited before twentieth day of every month stating the particulars of amount deposited to Reserve Bank of India.

8. Loans and Advances(Section 20)

It prohibits banks from granting any loans or advances to any of its Directors. However, banks can give loan to Chief Executive Officer/Whole Time Directors for purchasing of car, personal computer, furniture, constructing/acquiring a house for personal use, festival advance and credit limit under credit card facility.



CHECK YOUR PROGRESS

Q 1: In which year the Banking Regulation Act was passed?

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Q 2: In which year the Banking Companies Act, 1949 was renamed as the Banking Regulation Act?

.....

Q 3: State the purpose of the enactment of the Banking Regulation Act, 1949?

.....

Q 4: What did Banking Regulation Act vested in the Reserve Bank?

.....

Q 5: Which Section of Banking Regulation Act, 1949 deals with prohibition of trading?

.....

10.4 REQUIREMENTS AS TO MINIMUM PAID-UP CAPITAL AND RESERVES (SEC.11)

To ensure that no banking company commences or carries on business with a weak and vulnerable capital structure, section 11 lays down the following minimum limits of paid up capital and reserves to be complied with by a banking company which wishes to commence or carry on business in India.

The requirements of minimum paid-up capital for the banking company are detailed below:

a. A banking company incorporated in India having place of business in more than one state but not in the city of Mumbai or Kolkata or both-Rs.5 lakh.

b. A banking company incorporated in India having place of business in the city of Mumbai or Kolkata or both-Rs.10 lakh.

c. A banking company incorporated in India having place of business in one state but not in the city of Mumbai or Kolkata-Rs.1 lakh for the principal place of business plus Rs.10, 000 for the place of business in the same district plus Rs.25, 000 in respect of each place of business situated in other districts of the state with a maximum capital of an aggregate value of Rs.5 lakhs.

d. A Banking company having one place of business shall have a paid-up capital and reserves exceeding Rs.50, 000.

In the case of Banking Company incorporated outside India the aggregate value of its paid-up capital and reserves shall not be less than Rs.15 lakhs. If the place of business is situated in the city of Mumbai or Kolkata or both, the paid-up capital and reserves shall not be less than Rs.20 lakhs.

Banking companies incorporated outside India have to deposit the amount either in cash or in unencumbered securities or partly in cash and partly in securities with the Reserve Bank of India.

The capital of the banking company incorporated in India shall consist only of equity or ordinary shares.A banking company should not have any preference shares as its capital unless they were issued before 1st July, 1944.

10.5 CONSTITUENTS OF BOARD OF DIRECTORS (SECTION 10 A)

The Act seeks to include on the Board of Directors of a banking company persons having professional or other experience. It therefore provides that not less than 51% of the total number of members on the Board of Directors of a banking company shall consist of persons who satisfy the following conditions:

1. They shall have special knowledge or practical experience in respect of one or more of the following matters, namely:
   - (i) Accountancy
   - (ii) Agriculture and rural economy
   - (iii) Banking
   - (iv) Co-operation
   - (v) Economics
   - (vi) Finance
   - (vii) Law
   - (viii) Small-scale industry
   - (ix) Any other matter the special knowledge or practical experience in which would in the opinion of the Reserve Bankis useful to the banking company.

At least two of the aforesaid number of directors, shall be persons having special knowledge or practical experience in respect of agriculture and rural economy, co-operation or small-scale industry.

2. They shall not:
   a. Have substantial interest in, or be connected with, whether as employee, manager of
      (i) Any company, not being a company registered under section 25 of the Companies Act, 1956, or
      (ii) Any firm, which carries on any trade, commerce or industry and which, in either case, is not a small-scale industrial concern, or
   b. Be proprietors of any trading, commercial or industrial concern, not being a small-scale industrial concern.

Where the Reserve Bank is of opinion that the composition of the board of directors of a banking company is such that it does not fulfil the above requirements, it may, after giving to such banking company a reasonable opportunity of being heard, by an order in writing, direct the banking company to so re-constitute its board of directors as to ensure that the said requirements are fulfilled. If within two months from the date of receipt of that order, the banking company does not comply with the directions made by the Reserve Bank; the Reserve Bank may remove such persons from the board who do not satisfy the requirements prescribed and appoint suitable persons to fill in the vacancies so caused.

Moreover, a director of a banking company, other than its chairman or whole time director cannot hold office continuously for a period exceeding eight years. If the chairman or other whole time director of a banking company is removed from office as chairman/wholetime director, he shall also cease to be a director. He shall not be eligible to be reappointed as director of such banking company for a period of four years from the date of his ceasing to be the chairman/wholetime director.

10.6 LICENSING OF BANKING COMPANIES (SECTION 22)

Section 22 of the Banking Regulation Act contains the provisions relating to licensing of banking companies. According to this section, no company shall carry on banking business in India unless it holds a licence issued in that behalf by the Reserve Bank. The licence may be issued subject of such conditions as the Reserve Bank may think fit to impose .Every banking company in existence on the commencement of this Act, before the expiry of six months from such commencement and every other company before commencing banking business in India shall apply in writing to the Reserve Bank for a licence under this section.

Before granting any licence the RBI satisfies itself with the following conditions:

i. That the company is or will be in a position to pay its present or future depositors in full as their claims accrue.

ii. That the affairs of the company are not being, are not likely to be conducted in a manner detrimental to the interests of its present or future depositors.

iii. That the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors.

iv. That the company has adequate capital structure and earning prospects.

v. That the public interests will be served by the grant of a licence to the company to carry on banking business in India.

vi. That having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth.

vii. Any other condition, the fulfilment of which would, in the opinion of the

RBI be necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interests of the depositors.

Cancellation of licence: The RBI may cancel a licence granted to a banking company under the following circumstances:

i. If the company ceases to carry on banking business in India;

ii. If the company at any time fails to comply with any of the conditions imposed upon it.

Before cancelling the licence, the RBI gives sufficient opportunity to initiate steps to comply with the said conditions.

10.7 ACCOUNTS AND AUDIT (SECTION 29 AND SECTION 30)

Section 29 to 30 of the Banking Regulation Act contains the provisions in regard to accounts and audit of the banking companies.

A banking company is required to prepare a Balance Sheet and Profit and Loss Account every calendar year and get it audited by person qualified under law to be the auditor. However, the bank must obtain previous approval of the Reserve Bank before appointing or reappointing or removing of any auditor.

In case of a foreign bank,the profit and loss account may be prepared on a date earlier than two months before the last working day of the year. Reserve Bank is also empowered to direct the auditor of a banking company to audit any transaction or any class of transaction in the public interest or interest of the depositor. The auditor shall submit the report in the prescribed manner .The auditor report along with the accounts and balance sheet should be published and three copies of the same should be sent to the Reserve Bank as returns within the end of three months of the accounting period.

The registrar of companies shall also have three copies of the audited profit and loss account and balance sheet along with the auditor's report. The audited balance sheet and profit and loss account should have to be displayed in a conspicuous place in the principal office and in every branch office.

10.8 POWERS OF THE RBI

The RBI is the apex banking institution in India. It is the friend, philosopher and guide of the other commercial banks operating in the country. In order to control and regulate the activities of the commercial banks and thus to ensure healthy growth of banking industry in the country, Banking Regulation Act has vested some powers in the hands of the RBI. Some important powers are as follows:

1) **Licensing of Banking Companies:** According to Section 22 of the B.R. Act, no company can carry on banking business in India unless it holds a licence issued in that behalf by the Reserve Bank.

2) **Cancellation of Licence:** Section 22 of the Act empowers the RBI to cancel the licence granted to a banking company under the following circumstances:
   i. If the company ceases to carry on banking business in India.
   ii. If the company at any time fails to comply with any of the conditions imposed upon it under section 22(1).
   If at any time, any of the conditions referred to in section 22(3) and section 22(3A) is not fulfilled.

3) **Power of Reserve Bank to control advances by Banking Companies(Section 21):** Where the Reserve Bank is satisfied that it is necessary or expedient in the public where the Reserve Bank is satisfied that it is necessary or expedient in the public interest or in the interests of the depositors or banking policy so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy as so determined.

4) **Election of New Directors:** The Reserve Bank may, by order, require any banking company to call a general meeting of the shareholders of the company within such time, not less than two months from the date of the order, as may be specified in the order or within such further

time as the Reserve Bank may allow in this behalf, to elect in accordance with the voting rights permissible under this Act fresh directors and the banking company shall be bound to comply with the order.

5) **Appointment of Chairman and Managing Director:** The Reserve Bank has the power to appoint chairman of the board of directors or a managing director where the office of chairman appointed on a whole time basis or a managing director is vacant.

Every banking company has to take prior approval of the Reserve Bank for the appointment, reappointment,terminator or fixation of remuneration of chairman, managing director or any other director, wholetime or otherwise, manager or chief executive officer. Moreover any amendment of the provision relating to appointment or reappointment or remuneration of such persons shall not be effective unless approved by the Reserve Bank.

6) **Appointment of Additional Directors:** The RBI may if considers necessary for the protection of the interest of the depositors, from time to time, appoint additional directors on the board of the banking company. The number of directors so appointed shall not exceed five or one-third of the maximum strength of the Board of Directors, whichever is less.

7) **Power to give Direction (Section 35A) :** The RBI may from time to time issue directions to banking companies generally or to any banking company in particular-

   i. In the public interests; or
   ii. In the interest of the banking policy; or
   iii. In the interest of the depositors; or
   iv. To secure the proper management of any banking company generally.

8) **Power of Inspection:** The RBI at any time and shall at the direction of the central government inspect a banking company and its books and accounts to find out whether or not the affairs of the banking company are conducted in the interests of the depositors.

9) **Publication of Information:** The Reserve Bank may publish any information obtained by it under this Act in such consolidated form as it thinks fit in the public interest.

10) **Amalgamation and Winding up:** The scheme of amalgamation of two or more banking companies has to be approved by the Reserve Bank to be effective and valid. The Reserve Bank also has the power to apply to the High Court for the winding up of a banking company.

10.9 DEPOSIT INSURANCE IN INDIA

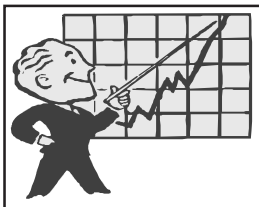
Deposit insurance is a measure implemented in many countries to protect bank depositors,in full or in part,from losses caused by a bank's inability to pay its debts when due.Deposit insurance systems are one component of a financial system safety net that promotes financial stability.

In India deposit insurance is provided by the Deposit Insurance and Credit Guarantee Corporation. It is a wholly owned subsidiary of Reserve Bank of India. It was established on 15 July 1978 under the Deposit Insurance and Credit Guarantee Corporation Act, 1961 for the purpose of providing insurance of deposits and guaranteeing of credit facilities. DICGC insures all bank deposits, such as saving, fixed current, recurring deposit for up to limit of Rs.100, 000 of each deposit in a bank. If the customer has accounts in different banks, all of those accounts are insured to a maximum of Rs.1, 00, 000.However, if there are more accounts in same bank, all of those are treated as a single account. The insurance premium is paid by the insured bank itself. This means that the benefit of deposit insurance protection is made available to the depositors or customers of banks free of cost. The Corporation has the power to cancel the registration of an insured bank if it fails to pay the premium of three consecutive half-year periods. The Corporation may restore the registration of the bank if the bank makes a request and pays all the amounts due by way of premium from the date of default together with interest.

The corporation covers all commercial and co-operative banks, except in Meghalaya, Chandigarh, Lakshadweep and Dadra and Nagar Haveli. Only primary cooperative societies are not insured by the DICGC.

All bank deposits-savings, fixed, current and recurring-payable in India are covered. However, the DICGC does not include the following types of deposits:

- Deposits of foreign governments.
- Deposit of central/state governments.
- Inter-bank deposits.
- Deposits of the state land development banks with the state cooperative bank.
- Any amount due on account of any deposit received outside India.
- Any amount specifically exempted by the DICGC with previous approval of RBI.



CHECK YOUR PROGRESS

Q 6: Does the bank require obtainingprior approval of the Reserve Bank before appointing or reappointing or removing of any auditor?

.....

Q 7: Which section of Banking Regulation Act 1949 give power to the Reserve Bank to give directions?

.....

Q 8: What is the purpose of deposit insurance?

.....



10.10 LET US SUM UP

In this unit we have discuss the following:

- The Banking Companies Act 1949 was renamed as the Banking Regulation Act from 1 March 1966.
- The Banking Regulation Act is legislation in India that regulates all banking firms in India. The Act provides a framework under which commercial banking in India is supervised and regulated.
- The Banking Regulation Act extends to the whole of India and is applicable to public sector, private sector and cooperative banks

(excluding primary agricultural societies, non-agricultural primary credit societies and cooperative land mortgage banks).

- As per Section 8 of the BR Act, a banking company cannot get in directly or indirectly contracts in buying or selling or exchange of goods.
- Section 11 lays down minimum limits of paid up capital and reserves to be complied with by a banking company which wishes to commence or carry on business in India
- As per section 22 of the BR Act, no company shall carry on banking business in India unless it holds a licence issued in that behalf by the Reserve Bank.
- In order to control and regulate the activities of the commercial banks and thus to ensure healthy growth of banking industry in the country, Banking Regulation Act has vested some powers in the hands of the RBI.
- In India deposit insurance is provided by the Deposit Insurance and Credit Guarantee Corporation which is a wholly owned subsidiary of Reserve Bank of India.



10.11 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.

10.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: 1949.

Ans to Q No 2: 1966.

Ans to Q No 3: The Banking Regulation Act, 1949 wasenacted to control the banks, safeguard the interest of the depositor and thus protect the economic interest of the country.

Ans to Q No 4: The Banking Regulation Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation.

Ans to Q No 5: Section 8.

Ans to Q No 6: Yes, the bank require prior approval of the Reserve Bank before appointing or reappointing or removing of any auditor,

Ans to Q No 7: Section 35 A.

Ans to Q No 8: Deposit insurance is a measure to protect bank depositors from losses caused by a bank's inability to pay its debts when due.



10.13 MODEL QUESTIONS

Q 1: Discuss the provisions of Banking Regulation Act,1949 relating to-

a) Minimum capital and reserves of banking companies

b) Constitution of Board of Directors

c) Licensing of banking companies

d) Accounts and Audit

Q 2: What are the forms of business that Banking Company may engage in besides the business of 'Banking'?

Q 3: Discuss the powers of the Reserve Bank of India in controlling and regulating the activities of Indian commercial banks.

Q 4: Under what circumstances the Reserve Bank of India can cancel licence granted to a banking company?

Q 5: Write a short note on Deposit Insurance in India.

*** ***** ***

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.

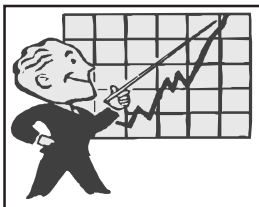
Sd/- ……

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-



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.

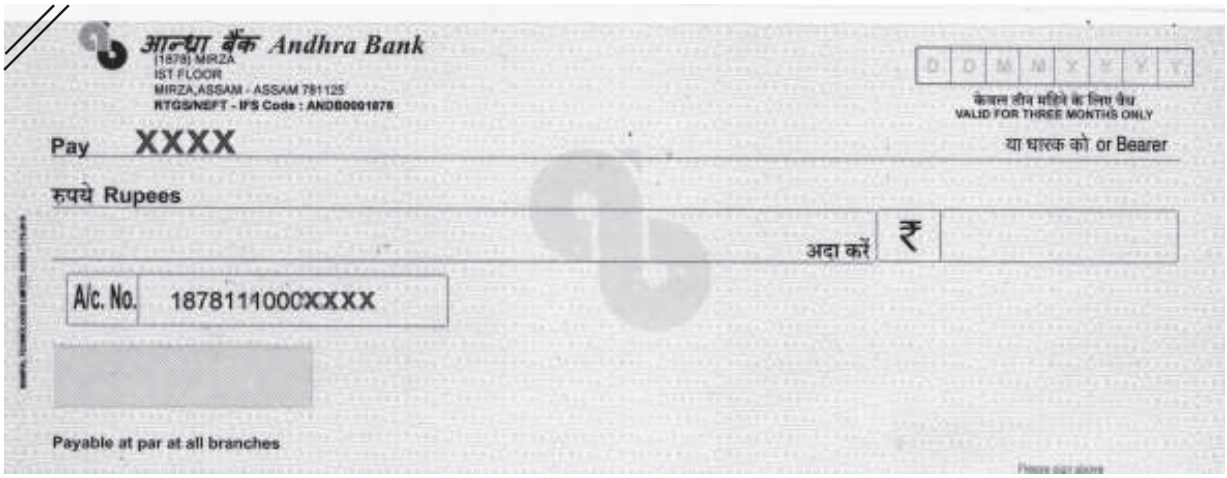


Figure: General crossing of a cheque

- **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.

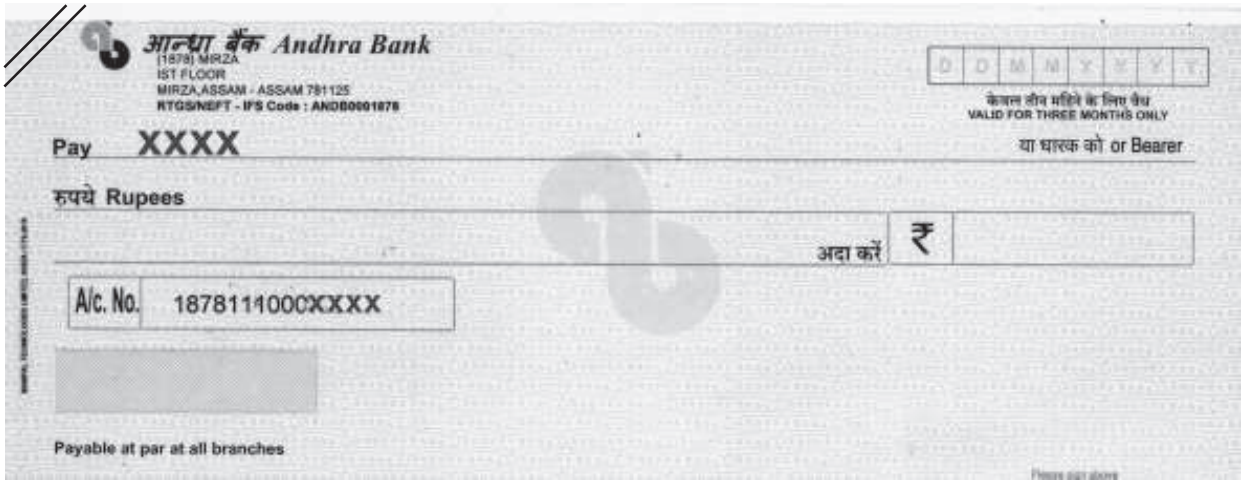


Figure: Special crossing of a cheque

- **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.

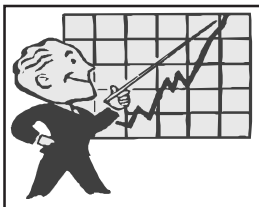
Now, what the term 'endorsement' mean? The term 'endorsement' means writing the name of the person on the back of the instrument to negotiate the instrument in favour of that person. Let us take an example. Mr. A wants to transfer a cheque to Mr. B. Now, Mr. A will write the name of Mr. B on the back 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.
ii. An order cheque can be paid to bearer.
iii. In general endorsement, the endorser is not required to put his signature.
iv. In restrictive endorsement the right of the endorser is restricted.
v. The amount of a specially crossed cheque must be paid to the specified banker.



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.



11.10 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.

11.11 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.



11.12 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.

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UNIT 12 : STATUTORY PROTECTION TO PAYING BANKER

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning of Paying Banker

12.4 Precautions to be taken by a Paying Banker to be

12.5 Circumstances for dishonour of cheques

12.6 Duties of Paying Banker

12.7 Statutory Protection available to a Paying Banker

12.7.1 Conditions for statutory protection

12.8 Payment of cheque by mistake

12.9 Payment of Domiciled Bills

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 studying this unit, you will be able to:

- understand the important aspects of the role of a banker as paying banker
- develop a perfect understanding of the procedures and precautions to be adopted by paying bankers.

12.2 INTRODUCTION

Banks maintain and operate accounts like savings bank account, current account, overdraft and cash credit accounts which are operated by the cheques drawn by the account holders on their bankers. While handling these cheques, a banker may act as a paying banker (when cheques are drawn on him).Banks are under a statutory obligation to honour a cheque

and make payment if it is in order as per relevant laws.This obligation of the banker as the drawee of a cheque,is very delicate and of crucial importance. As a matter of fact,this is the basis on which banking business is carried on.

In this unit we will discuss the meaning, duties, Statutory Protection available to Paying Banker etc.

12.3 MEANING OF PAYING BANKER

The term 'Paying Banker' is used to denote the position and duties of the drawee bank in regard to the payment of cheques drawn on it by its customer. The money of the customer in his bank account is payable on demand by honouring the cheques drawn by the customer and presented by the legitimate holder. This is an implied contract between the banker and the customer. Thus, the banker on whom a cheque is drawn or the banker who is required to pay the cheque drawn on him by a customer is called the paying banker.

12.4 PRECAUTIONS TO BE TAKEN BY A PAYING BANKER

It is said that a banker is between the deep sea and the devil, when a cheque is presented to him for payment because a wrongful payment will not entitle him to debit the account of the customer or he can be sued by the customer for the loss of his credit if he wrongfully dishonour the cheque. In order to protect its as well as the customer's interests, the paying banker should take the following precautions while making payment of his customer's cheques:

1. **Precaution regarding form of the cheque:**The cheque should be in proper form. Although the Negotiable Instruments Act does not specify the form of a cheque,banks have the practice of issuing printed cheques for use by the customer.Infact,banks specify the rules of operating the account by the customer. Banks reserve the right of dishonouring a cheque in case it is not in the prescribed form. In such cases banks may not honour a cheque which is not in the prescribed

form. In the absence of any such rule the bank should honour the cheques,though not in proper form if it happens to be an unconditional order and it fulfils other conditions.

2. **Precaution regarding 'date':** A cheque must bear a date mentioned on the instrument .The date must be complete. It must mention the day, month and the year. This is needed to make the cheque effective. However, a cheque that does not bear a date does not become invalid. The holder may as well fill up the date before presenting it for payment. But if an undated cheque is presented for payment, the banker must refuse its payment.

   If a cheque is ante dated i.e a cheque that mentions a date earlier to the date of writing the cheque,it may be paid if it has not become stale by that time. A cheque that contains a date, which has elapsed the maximum permissible period of validity, is called a stale cheque. If a cheque is post- dated, i.e. it bears a date which is yet to come, he should honour it only on its due date.

3. **Precaution regarding 'amount':** The amount of cheque presented for payment has to be recorded in both words and figures and they should tally with each other.

4. **Precaution regarding 'funds' of the customer:** There should be sufficient funds in the account of the customer for payment of the cheque. If the funds available are not sufficient to honour a cheque, the paying banker is justified in returning it. So, before honouring a cheque, he must check-up the present state of his customer's account.

   The cheque should be paid in chronological order of their receipt by the bank. Accordingly, a cheque that is received first will be paid first. The date of their issue or serial number is not significant in this respect. Therefore, in case of inadequacy of funds ,the cheques will be paid in the order in which they are received by the bank to the extent the funds permit and the rest will be dishonoured.

5. **Precaution regarding material alteration:** The paying banker should refuse payment in respect of a materially altered cheque. Material

alteration refers to change introduced on a cheque, which affects its fundamental character. Example-alteration of date, place of payment, crossing, amount, etc. If payment is made on a materially altered cheque, the banker will be liable to the drawer. However, he can be discharged from the liability only in the following circumstances:

- The alteration could not be detected with reasonable care,prudence and scrutiny.
- The payment had been made in due course.

6. **Precaution regarding drawer's signature:** It is an important duty of the paying banker to verify the genuineness of the drawer's signature with the details of the 'specimen signature' kept in the records of the banker.Payment is to be made only on the satisfaction that the signature of the drawer on the cheque is similar to the 'specimen signature'.When there is a joint account,both or all the signatures on the cheque should be genuine.In case any one of the signatures is forged,the bank should not make payment.
7. **Precaution regarding mutilated cheque:** A cheque is said to be mutilated when it is torn into two or more pieces.Such a cheque should not be paid unless the banker is satisfied that mutilation was unintentional and it also obtains confirmation of the drawer.
8. **Precaution regarding banking hours:**The banker should make payment of only such cheques which have been presented to it for payment during its banking hours.Any payment of cheque which was presented after banking hours will not be taken as a payment in due course and the banker will not be entitled to debit the customer's account if in the meanwhile the customer has countermanded the payment or some similar event had happened.
9. **Precaution regarding crossing:** If the cheque is crossed one,it should not be paid on the counter but through a collecting banker.If the payment is made in negligence of the same the banker will not be eligible for the statutory protection.

12.5 CIRCUMSTANCES FOR DISHONOUR OF CHEQUES

A paying banker is under a legal obligation to honour his customer's mandate.He is bound to do so under his contractual relationship with his customer.A wrongful dishonour will have the worst effect on the banker.However,under the following circumstances,the payment of a cheque must be refused.

1. **Countermanding:** Countermanding is the instruction given by the customer of a bank requesting the bank not to honour a particular cheque issued by him.When such an order is received,the banker must refuse to pay the cheque.
2. **Insufficiency of funds:** A banker can refuse payment on a cheque when the balance to the credit of the customer is insufficient to meet the cheque.
3. **Improper cheques:**A banker can refuse payment on a cheque which is not applicable for payment such as drawing personal cheques to be paid out of trust accounts.
4. **Death of the principal drawer:** A banker has to refuse payment by stopping payment of all cheques drawn against the account of the principal drawer-customer upon receiving the notice or information of death.The banker should not rely on rumours and should ascertain the news of the customer's death from reliable sources.The operation of the account is to be permitted only on the successor producing the succession certificate or probate of the will or a letter of administration.
5. **Insolvency of the principal drawer:** A banker has to refuse payment by stopping payment of all cheques drawn against the account of the principal drawer-customer on whom insolvency petition has been filed and must close the account and intimate the balance of the account to the official receiver on passing of order of adjudication.The banker must stop payment from joint account till their respective shares are determined in the event of the joint account holder being declared insolvent.

6. **Liquidation of the company:** In the event of liquidation of the company no cheques signed by the directors,etc.should be paid by the bank from the company's account as the powers of the directors and managerial personnel cease on the commencement of winding up and they vest in the liquidator.

7. **Other circumstances:** In addition to the above,the banker should refuse payment under the following circumstances:
   - When the customer informs the bank about the loss of the cheque.
   - When the customer informs the bank about the defect in the title of the person presenting a cheque.
   - When the bank comes to know about improper use of application of funds in breach of trust .
   - When the bank receives notice of an assignment of credit balance by a customer.
   - When the customer closes the account before the cheque is presented for payment.
   - When the cheque is post-dated and is presented for payment before its ostensible date.



CHECK YOUR PROGRESS

Q 1: Who is a Paying Banker?

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Q 2: What is mean antedated cheques?

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Q 3: What is mean post-dated cheques?

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Q 4: Define stale cheques?

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12.6 DUTIES OF A PAYING BANKER

1. A banker on whom a cheque is drawn should pay the cheque when it is presented for payment.
2. A banker is bound to honour his customer's cheque,to the extent of the funds available and the existence of no legal bar to payment.
3. The payment should be made during banking hours.
4. The paying banker should use reasonable care and diligence in paying a cheque,so as to,abstain from any action likely to damage his customer's credit.
5. He should not make payment of crossed cheque at the counter,i.e.crossed cheque should be paid through a banker if cheques are crossed generally or through the specified banker in case of special crossing.

Thus, the paying banker must make the payment as per the provisions of the Negotiable Instruments Act.The paying banker should act with care and caution and prudence in honouring the cheque.

In case of crossed cheques:

The paying banker is under an obligation to make payment of the crossed cheques in accordance with the instruction of the drawer conveyed through the crossing. The paying banker should make the payment of a crossed cheque only through the collecting banker. In case of special crossing the payment of cheque should be done only to the banker whose name has been mentioned between the two transverse parallel lines. In case the paying banker makes payment of a crossed cheque in contravention of the above rules, its liability will be as follows:-

(i) The paying banker will have to reimburse the true owner for any loss that he might have suffered on account of payment being made to a wrong person.

(ii) The paying banker shall not be entitled to debit his customer's account with the amount of payment if payment has been made to a wrong person since it has not followed the mandate of the customer.

12.7 STATUTORY PROTECTION AVAILABLE TO A PAYING BANKER

The legal duty of a paying banker is full of risk because payment of cheques may not be made to the right person. In case a payment is made to a wrong person by bank, the loss will be borne by the banker. In banking practice, the banker honours the cheques of his customers and cannot make enquiries and investigations about the title and status of the person who presents the cheque for payment at the counter of the bank. If enquiries were to be made, much expenditure of time and money would be involved and instrument could only be nominally payable on demand and indeed the system would be impossible. The Negotiable Instruments Act has come to the rescue of the paying banker and provided protection under certain circumstances. These circumstances are given below:-

1. **Protection in case of bearer cheque:** Section 85(2) of the Negotiable Instruments Act,1881 gives protection on the basis that a bearer cheque always remains a bearer cheque and it bears endorsement in blank or full whether any endorsement restricts further negotiation or not.In case a bearer cheque is stolen or lost and the banker honours the cheque without any knowledge, the banker will be discharged from his duty under the protection given in the Act.In such a case, the paying banker is not required to verify the endorsement on bearer cheque.
2. **Protection in case of order cheque:** In case the payment is made to a person other than the payee, the paying banker does not get any protection under the Negotiable Instruments Act. If the endorsement is regular and payment is made in due course, the paying banker gets the protection under section 85 (1) of the Negotiable InstrumentsAct,1881.

   Thus, where a cheque payable to order purports to be endorsed by or on behalf of the payee, the paying banker is discharged by payment in due course. However, two conditions must be fulfilled to avail such protection. These are (a) Endorsements, if any, should be regular and (b) Payments thus made amounts to payment in due course.

3. **Protection in case of crossed cheque:** According to Section 128 of the Negotiable Instruments Act the statutory protection to paying banker also extends to crossed cheque. This section of the law lays down that "Where a banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque and (in case such cheques has come to the hands of the payee)the drawer thereof, shall respectively be entitled to the same rights and be placed in the same position in all respects, as they would respectively be placed if the amount of the cheque had been paid to and received by the true owner thereof".

   The paying banker is entitled to statutory protection under the law if (a)The banker has made payment in due course, and (b) The payment has been made in accordance with the requirements of the crossing i.e. payment made through any banker in case of general crossing and through specified banker in case of special crossing.

4. **Protection in case of obliterated cheque:** Section 89 of the Negotiable Instruments Act provides protection to the banker in case of obliterate cheques. According to this section where crossing of a cheque is obliterated by dishonest person, the paying banker shall get protection if he makes payment of such a cheque according to the apparent tenor of the cheque and in due course.

5. **Protection in case of drafts drawn by one office of a bank on another office of the same bank:** A draft is not a cheque, but it is treated as cheque for the purpose of protection of the bank. The drawee banker is given statutory protection on draft drawn by one office of a bank on another office of the same bank under Section 85A of the Negotiable Instruments(Amendment) Act,1930.This section of the act states that, "Where any draft, that is 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, purports to be endorsed by or on behalf of the payee, the bank is discharged by payment in due course".

12.7.1 Conditions for statutory protection

1. Enables the banker to protection only in case of cheques that turns out to be wrongly endorsed.
2. It offers no protection to the banker if the drawer's signature is forged.
3. There must be payment in due course.

12.8 PAYMENT OF CHEQUE BY MISTAKE

A banker has to exercise utmost care before making payment on a cheque.The genuineness of the cheque has to be verified before making payment.If however, payment is made on a wrong cheque by mistake,it is possible for the paying banker to recover the amount of the cheque from the payee.For this to happen,it is essential that the payee's position should not have been altered to the disadvantage of the paying banker before the detection of mistake. It is upto the conscience of the payee who has wrongly taken payment from the banker to return the same to the drawer.This is based on the Doctrine of Equity.

Under the following circumstances, money wrongly paid can be recovered:

i. **Money received mala fide is recoverable:** When a person receives money by mistake in bad faith, knowing that he is not entitled to receive that money, then the banker is entitled to recover the same.

ii. **Money paid under a mistake of fact is recoverable:** I f the mistake is a mistake of fact,then the money wrongly paid is recoverable. Forinstance, a banker pays money to X, thinking that he is Y. This is a mistake of fact regarding the identity of the parties.Y is under a legal duty to pay the money back to the banker.

iii. **Mistake between the party paying and the party receiving:** If the mistake is between the party paying and the party receiving, then the money is recoverable. For instance, a banker by mistake, pays a cheque to X, the payee, in the absence of sufficient balance in the account of the drawer. In such circumstances, the banker cannot

recover the money paid by mistake because the mistake is not between the party paying (banker) and the party receiving (X), but it is between the banker and the drawer.

For example, if the cheque is of Rs.580 and if by mistake the banker pays Rs.850, he can recover the excess amount paid before the payee leaves the bank premises. If the payee leaves the premises, the banker has to prove that the payee received the amount knowing it was an excess payment.

Under the following circumstances, money wrongly paid cannot be recovered:

i. If it is the mistake relating to general law.

ii. If the agent receives the payment on behalf of the principal and returns the amount to his principal.

iii. If a bank pays a bill of exchange before it matures due to mistake with regard to the due date.

iv. If the money is paid in good faith to the holders,and the holders in good faith received the same during some interval may alter their position accordingly.In other words,money paid in excess on a negotiable instrument is not recoverable under a notice of claimafter reasonable delay.

Thus, recovery of money paid by mistake depends upon the actual circumstances.

12.9 PAYMENT OF DOMICILED BILLS

When a drawee accepts a bill of exchange elsewhere than at his place of business or private address, the bill is said to be domiciled at the place of payment. A banker is under no obligation to pay bills made payable at the bank by the customer,unless the banker has expressly or through implication agree to pay bills domiciled with him.

Generally, bankers take a mandate from the customer before agreeing to pay bills domiciled with him.This mandate includes an understanding by the customer that he will not hold the banker liable in case the bill bears a forged endorsement on domiciled bills.

Payment of bills by which the Bank acts as a special payer (domiciliary agent)is the Bank's execution on behalf of a principal payer on bills(domiciliary)of bills operations based on the instructions received from the principal,specifically:

- Acceptance of the bills of exchange from the bill holder
- Making payment on bills of exchange
- Transfer of bills to the bill payer after the full payment of bills

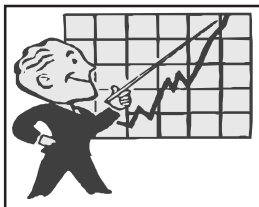
A Bank can be appointed as a special payer (domiciliary)for both ordinary bills and transfer bills of exchange.

If a special payer (domiciliary)is not specified by the drawer,it may be appointed by the payer upon acceptance. However, the payer cannot change the place of payment(settlement).Changing the place of payment upon the bill acceptance is equivalent to a refusal to accept it. If the bill of exchange is payable at the place of the payer's residence, he may, upon its acceptance, indicate another address in the same location(settlement).

Given the instructions of the principal, the Bank may accept bills of exchange for payment and make payment on them at the expense of the principal.The principal may be the drawer,the bill acceptor,or the payer of the transfer bill of exchange.

In this settling,the Bank becomes a special payer(domiciliary)and pays a bill of exchange only if the principal had primarily paid him the bill amount.

The conditions governing the payment of bills are,by and large,similar to those applicable to the payment of cheques.Thus,the banker should satisfy himself regarding the correctness in form,regularity of endorsements,genuineness of the acceptor's signature,etc.However,it is not the duty of the banker to see whether the signature of the drawer is genuine.It is the duty of the acceptor to make sure that the signature of the drawer is genuine.When performing an operation,the Bank is responsible only for the proper execution of the principal's instructions specified in the agreement.



CHECK YOUR PROGRESS

Q 5: What are the two conditions to be fulfilled to avail protection under Section 85 (1) of the .

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Q 6: Can a banker recover money paid by mistake?

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Q 7: What is meant by Domiciled Bill?

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12.10 LET US SUM UP

In this unit we have discuss the following:

- There is a contractual relationship between banker and a customer.
- The banker is under duty to pay customer on demand.
- While handling cheques, as a paying banker, he should act very cautiously and judiciously. He must take utmost care in honouring or dishonouring a cheque drawn by his customer.
- The paying banker is at the statutory obligation to pay cheque amount out of the balance available to his customer as per the direction of the customer. As such the paying banker is given protection under certain circumstances of honouring the cheque of his customer.
- Since, thousands of transactions takes place in a bank everyday, it is quite natural that mistakes do occur. Bymistake, a banker may pay money to a wrong person. But a banker can recover the money paid by mistake without adversely affecting the other party.
- Payment of bills by which the Bank acts as a special payer (domiciliary agent) is the Bank's execution on behalf of a principal payer on bills (domiciliary) of bills operations based on the instructions received from the principal.



12.11 FURTHER READING

1) Banking Theory, Law and Practice by E. Gordon & K.Natarajan.

2) Banking Theory, Law and Practice by Dr. S Gurusamy.

12.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The banker who makes payment of a negotiable instrument is called a 'paying banker'

Ans to Q No 2: A chequethat mentions a date earlier to the date of writing the cheque,is called an ante dated cheque.

Ans to Q No 3: A chequethat bears a date,which is yet to come,is called a post-dated cheque.

Ans to Q No 4: A cheque that contains a date,which has elapsed the maximum permissible period of validity,is called a stale cheque.

Ans to Q No 5: (a)Endorsement must be regular.

(b) Payment must be made in due course.

Ans to Q No 6: Yes,a banker can recover money paid by mistake.

Ans to Q No 7: Domiciled bill of exchange is such a bill of exchange where the place of payment is not same place of permanent residence of the drawee.



12.13 MODEL QUESTIONS

Q 1: Discuss the statutory protection enjoyed by a paying banker while paying the following:

i) Bearer cheque

ii) Order cheque

iii) Cross cheque

Q 2: State the precautions to be taken by a paying banker while making payment of cheques.

Q 3: Enumerate the circumstances under which a banker must refuse to honour a customer's cheque.Discuss his liability in the case of wrongful dishonour of a cheque.

Q 4: Explain the duties and liabilities of a paying banker.

Q 5: Write a short note on:

a) Payment of cheque by mistake.

b) Payment of Domiciled Bills.

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UNIT 13 : STATUTORY PROTECTION TO COLLECTING BANKER

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning of Collecting Banker

13.4 Precaution to be taken by a Collecting Banker

13.5 Collecting Banker as Holder for Value

13.6 Collecting Banker as an Agent

- 13.6.1 Conversion by the Collecting Banker
- 13.6.2 Circumstances when conversion is said to have been done
- 13.6.3 Liability of the collecting banker for the act of conversion

13.7 Duties of Collecting Banker

- 13.7.1 Procedure for collection

13.8 Statutory Protection of Collecting Banker

13.9 Basis of Negligence

13.10 Let Us Sum Up

13.11 Further Reading

13.12 Answers To Check Your Progress

13.13 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- understand the fundamental aspects of the role of a banker as collecting banker.
- know about the legal aspects of banking operations and the precautions taken by banks.

13.2 INTRODUCTION

Collection of cheques, bills of exchange and other instruments on behalf of a customer is an indispensable service rendered by a modern banker to his customer. Collection of cheques has now become an important function of a banker with the growth of banking habit and with wider use of crossed cheques,which are invariably to be collected through a banker only.While collecting his customer's cheques,a banker acts either

(i) As a holder for value,or

(ii) As an agent of the customer.

The legal position of the collecting banker, therefore, depends upon the capacity in which he collects the cheques.It does not make any difference if the collecting banker presents the cheque through the clearing house.

In this unit we will discuss the meaning, duties, Statutory Protection available to Collecting Banker.

13.3 MEANING OF COLLECTING BANKER

When a customer of a banker receives a cheque drawn on any other banker he has two options before him-(1)either to receive its payment personally or through his agent at the drawee bank or (2)to send it to his banker for the purpose of collection from the drawee bank. In the latter case the banker,deputed to collect the amount of the cheque from another banker,is called the collecting banker.He presents the cheque for encashment to the drawee banker and on its realisation credits the account of the customer with the amount so realised.

Thus a banker who undertakes the task of collecting cheques and other instruments of credit from the drawee bank is called a 'collecting banker'.

13.4 PRECAUTION TO BE TAKEN BY A COLLECTING BANKER

A collecting banker should take the following precautions while collecting cheques:

1. He should receive the payment of the cheque only for a customer and not for a stranger.
2. He should collect only crossed cheque.
3. He should collect cheque in his capacity as an agent of his customer and not as a holder for value.
4. He should closely examine the title of the customer to the cheque by verifying the regularity of endorsement and other content of the cheque.
5. He should act in good faith and without negligence.

13.5 COLLECTING BANKER AS HOLDER FOR VALUE

Collection of cheques takes some time, especially in case of outstation cheques.If the collecting banker pays to the customer the amount of the cheque or credits such amount to his account and allows him to draw on it, before the amount of the cheque is actually realised from the drawee banker, the collecting banker is deemed to be its 'holder for value'. He takes an undertaking from the customer to the effect that the latter will reimburse the former in case of dishonour of the cheque.

A banker becomes its holder for value by giving its value to the customer in any of the following ways:

a) By lending further on the strength of the cheque;
b) By paying over the amount of the cheque or part of it in cash or in account before it is cleared;
c) By agreeing either then or earlier,or as a course of business,that customer may draw before the cheque is cleared;
d) By accepting the cheque in avowed reduction of an existing overdraft;and
e) By giving cash over the counter for the cheque at the time it is paid in for collection.

13.5.1 Effects

Where a banker plays the role of a holder for value,the following consequences emerge:

1. If the last but one endorsement is proved to be forged, he will be liable to the true owner of the cheque.
2. Possessing the right to recover the money from the last endorser,i.e.his own customer.
3. If the customer is unable to pay,the banker himself will bear the loss.
4. If the cheque sent for collection is returned dishonoured,the collecting banker can sue all the previous parties after giving them notice of dishonour.It is however, essential that the amount of the cheque is paid to the customer in good faith.

13.6 COLLECTING BANKER AS AN AGENT

A collecting banker acts as an agent of the customer if he credits the latter's account with the amount of the cheque after the amount is actually realised from the drawee banker. There after the customer is entitled to draw the amount of the cheque.The banker thus acts as an agent of the customer and charges from him a commission for collecting the amount from outstation banks.

As an agent of his customer, the collecting banker does not possess title to the cheque better than that of the customer. If the customer has no title thereto, or his title is defective, the collecting banker cannot have good title to the cheque.In case the cheque collected by himdid not belong to his customer, he will be held liable for'conversion of money'.

13.6.1 Conversion by the Collecting Banker

Conversion means wrongful or unlawful interference (i.e.using, selling, occupying or holding)with another person's property which is not consistent with the owner's right of possession.Sometimes a banker is charged for having wrongfully converted cheques to which his customer had no title or had defective title.Thus the collecting banker has to be very careful while accepting his customer's cheque for collection.It is obligatory on every banker

to see that his customer possess clean titles or there should not be any defect in their titles.If the banker collects the proceeds of a cheque for a person who has either no title or a defective title,he will be held liable for the act of conversion.

The underlying principle of 'conversion' is that a rightful owner of the goods can recover the same from anyone who takes it without authority and in whose hands it can be traced.The collecting banker while acting as an agent of the customer does not obtain a better title to the cheque than that of the customer.

13.6.2 Circumstances when conversion is said to have been done

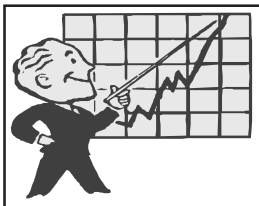
The following points are to be considered in this regard:

1) Collection of a cheque for a customer who has no title of a defective title.
2) Collection of a cheque bearing forged endorsement.
3) In case of 'not negotiable'crossed cheques,where the title of the parties is defective.

13.6.3 Liability of the collecting banker for the act of conversion

The following is the liability :

1) The collecting banker would be liable to the true owner and has to indemnify the losses,if any.
2) The collecting banker would lose the statutory protection granted by law.



CHECK YOUR PROGRESS

Q 1: Who is a collecting banker?

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Q 2: How does a collecting banker become a 'holder for value'?

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Q 3: What is meant by conversion by the collecting banker?

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Q 4: What is the underlying principle of 'conversion'?

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.....

13.7 DUTIES OF COLLECTING BANKER

The duties of a collecting banker towards its customers are as follows:

1. **Due care and diligence in the collection of cheques:** A collecting banker should exercise due care and diligence in collection of cheques entrusted to it for collection by its customer. It must predent them for payment within a reasonable time to the drawee bank. According to banking customs if the collecting and paying bankers are in the same place, the collecting banker should present it by the next day. In case they are at different places,the cheque must be despatched for collection by the day next after the day on which it was received by the collecting banker. In case the collecting banker fails to present the cheque, within the reasonable time,and in the meanwhile the drawee bank fails, the collecting banker will be responsible to the customer to the extent of the damage.

   However, the collecting banker will not be liable for any loss to the customer in case it has not been negligent in performance of its duties.

2. **Serve notice of dishonour:** In case the cheque is dishonoured, the collecting banker must within a reasonable time give notice to the customer so as to enable him to take action against the prior parties. In case the banker fails to serve notice of dishonour to the customer,it will be liable to the customer for any loss that the customer might have suffered on account of such a failure.In case a cheque isreturned by the drawee bank for confirmation of endorsement, it is not dishonour,

but in such case also notice should be given to the customer. If such notice is not given and the cheque is returned second time and the customer suffers a loss,the collecting banker may be held liable for that loss.

3. **Present the bill for acceptance at an early date:** As per Section 61 of the NI Act,a bill of exchange must be accepted.Acceptance gives an additional currency to the bill because the drawee becomes liable thereon from the date of acceptance.Moreover,in the case of a bill of exchange payable after sight,acceptance is absolutely essential to fix the date of maturity.If a banker undertakes to collect bills,it is his duty to present them for acceptance at any early date.Sooner a bill is presented and got accepted,earlier is its maturity.
4. **Present the bill for payment:** The banker should present the bills for payment in proper time and at proper place.If he fails to do so and if any loss occurs to the customer,then the banker will be liable.According to Sec.66 of the NI Act,a bill must be presented for payment on maturity.As per Sec.21,sight bills are payable on demand.Sec.22 lays down that the maturity of the bill is the date on which it is due for payment,to which,3 days of grace are added.Thus the rules for calculating the maturity dates are given in Secs.23,24 and 26 of the NI Act.
5. **Protest and note a foreign bill for non-acceptance:** In case of dishonour of a bill by non-acceptance or non-payment, it is the duty of the collecting banker to inform the customer immediately. Generally, he returns the bill to the customer.In the absence of specific instructions,collecting bankers do not get the inland bills noted and protested for dishonour.If the bill in question happens to be a foreign bill, the banker should have it protested and noted by a Notary Public and then forwarded it to the customer.

13.7.1 Procedure for collection

The collecting banker should follow the following procedure while collecting the proceeds of the cheques deposited by his

customers.

1) The person depositing the cheque must be a customer of the bank and must have an account.
2) The cheque must necessarily be a crossed one.
3) If it is endorsed,it should be a regular endorsement to show that the customer has a clear title.
4) If the banker suspects upon the clear title of the customer, the must insist upon proper proof in this regard.
5) There should not be any delay in presenting the cheque to the drawee bank.
6) Until and unless information is received from the paying banker about the payment,the customer's account should not be credited.

13.8 STATUTORY PROTECTION OF COLLECTING BANKER

Section 131 of the Negotiable Instruments Act 1881,provides protection to a collecting banker who receives payment of a crossed cheque or draft on behalf of his customer.Under this provision,a collecting banker will not be liable to compensate the true owner of the cheque for receiving the payment if the customer's title to the cheque is defective.

Thus the Negotiable Instruments Act provides statutory protection to the collecting banker against the risks of conversion.This is a high privilege given to the collecting banker.The objective is to minimize the risk of conversion inherent in the case of collection of cheque by the banker keeping in view the importance of the banking business in the nation's economy.

The statutory protection is however available to a collecting banker only if he fulfils the following conditions:

1) Crossed Cheque: In order to avail statutory protection, it is very important that the cheque must be a crossed one. The crossing can be a general crossing or a special crossing. Further, the drawer himself must have done the crossing before depositing it with the banker for collection. Protection is therefore not available if the collecting banker

makes a crossing after having received the cheque. The banker will otherwise be liable for conversion if the title of the customer proves to be defective or the endorsement thereon turns out to be a forged one.

2) **Payment for customer:** To be able to avail the statutory protection,the collecting banker should have received payment on behalf of a customer from the drawee's bank. For this purpose, the term 'customer'mean any person who has an account with the banker and whose dealings with the banker are in the nature of banking business. Accordingly,no protection is available to the collecting banker if cheques are sent to the bank by a person who is not a customer of the instrument.

3) **Collection as an agent:** The statutory protection can be claimed by a banker only for those cheques collected by him as an agent of the customer and not as a holder for value.As a holder for value the collecting banker becomes the rightful owner of the instrument.

4) **In good faith and without negligence:** In order to get the protection under this section, a collecting banker must act in good faith and without negligence. This applies to the whole transaction from the receipt of the cheque from the customer to the receipt of the proceeds from the paying banker.

13.9 BASIS OF NEGLIGENCE

There has been considerable difference of opinion,as to,what constitutes negligence for the purpose of Sec.131of the Negotiable Instruments Act,1881. It should be noted that negligence under this section is more or less artificial,as there is no contractual relationship between the collecting banker and the true owner of the cheque giving rise to a duty on the part of the former to the latter.His duty is only to his own customer.

The following definition of the term negligence was given in W.Walbank & Co. Ltd. Vs. Westministe r Ltd., 'Negligence is the doing of that which a reasonable man under all the circumstances of the particular case in which he is acting,would not do,or the failure to do something,which a reasonable man under those circumstances would do. 'The doctrine of

negligence is so shifting in its implication,that,it cannot be said with certainty as to what constitutes negligence.

For a proper understanding,negligence can be studied under the following heads:

1. Gross Negligence
2. Negligence connected with the immediate collection of cheque.
3. Negligence under remote grounds.
4. Contributory negligence.

1. Gross Negligence: If a banker is completely careless in collecting a cheque, then he will be held liable under the ground of 'Gross Negligence'.

Examples:

(i) Collecting a cheque crossed 'A/cpayee'for other than the payee's account: Account payee crossing is a direction to the collecting banker. If he collects a cheque crossed 'A/c payee 'for any person other than the payee,then this fact will be proved as an evidence of gross negligence.

(ii) Failure to verify the correctness of endorsement: If a banker omits to verify the correctness of endorsements on cheques payable to order, he will be deprived of the statutory protection.

(iii) Failure to verify the existence of authority in the case of per pro signatures: If a collecting banker fails to verify the existence of authority in the case of per pro signatures, if any, it will be proved as an evidence of gross negligence.

2. Negligence connected with the immediate collection of cheque: If, on the face of a cheque,there is a warning that there is misappropriation of money,the collecting banker should not disregard such warning.He should make some reasonable enquiry and only after getting some satisfactory explanations,he can proceed to collect cheques.

Examples:

(i) Collecting a cheque drawn against the Principal's A/c, to the Private A/c of the agent without enquiry:In Midland Bank vs.

Reckitt, a solicitor named Lord Terrington, with a special power of attorney, drew cheques on Reckitt's account and paid them into his private account with Midland Bank, who collected them for him. It was held that the banker was negligent in not making proper enquiry, and so, he could not get protection under Sec.131.

(ii) Collecting a cheque payable to the firm to the private account of a partner without enquiry: In Bevan Vs. The National Bank Ltd.,the banker had collected a cheque payable to the firm to the private account of the partner,who was authorised to operate the account.It was held that the banker was liable for conversion.

(iii) Collecting a cheque payable to the company to the private account of a director or any other officer without enquiry: In Underwood Vs. The Bank of Liverpool and Martins,since the banker had collected a number of cheques payable to the one man company,to the private account of a sole director,he was held to be negligent and answerable to debenture holder.

(iv) Collecting a cheque payable to the employer to the private account of the employee would constitute negligence under Sec.131 of the NI Act.

(v) Collecting a cheque payable to the trustee, to the private account of the person operating the trust account is another instance of negligence of a banker.

3. Negligence under Remote Grounds: Normally, one cannot expect a banker to be liable under certain circumstances. But, the bankers have been negligent under those situations which are branded as 'remote grounds.'

Examples:

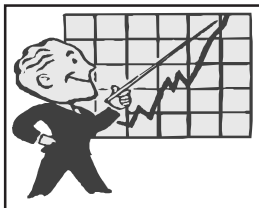
(i) Failure to ascertain the name of the employer of a new customer constitutes negligence under Sec.131.

(ii) Omission to obtain a letter of introduction from a new customer causes negligence.

(iii) Failure to enquire into the source of supply of large funds into an account which has been kept in poor condition for a long time constitutes negligence.

4. **Contributory Negligence:** In fact, this is a guise under which a collecting banker escapes from his negligence. It is possible that a collecting banker, even after accepting negligence on his part,can plead for contributory negligence. That is, if the customer's negligence is the proximate cause of the loss, then the customer will be liable.

Thus the word 'negligence' has no definite meaning in banking law.It has been very widely interpreted by courts of law frequently to the detriment of banker. It is flexible and is ever expanding in its scope as new circumstances arise.



CHECK YOUR PROGRESS

Q 3: What does Section 131 of the Negotiable Instruments Act,1881 contain?

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13.10 LET US SUM UP

In this unit we have discuss the following:

- The collecting banker is the link between the payee and the drawee of a cheque i.e.paying banker.
- A collecting banker undertakes the task of collecting cheques of his customer in the capacity of either as a holder for value or as an agent of the customer.
- The collecting banker is deemed to be its holder for value when a banker pay the amount of the cheque before the collection of the cheque drawn upon another banker and thus several consequences emerge.
- A collecting banker acts as an agent of the customer if he credits the customer's account with the amount of the cheque after it is actually realised from the drawee banker.
- The collecting banker would be liable to the true owner and has to indemnify the losses,if any in case of conversion.

- The collecting banker acts as an agent of his customer and is responsible to him for his acts of omissions or mistakes and as such there are several duties of a collecting banker towards his customers liketaking due care and diligence in the collection of cheques, serving notice of dishonour,etc.
- Keeping in view the importance of the banking business in the nation's economy and in order to minimise the risks of conversion inherent in case of collection of cheques by the bankers,Negotiable Instruments Act provides statutory protection to the collecting banker against the risk of conversion.
- The most essential prerequisite for availing of the statutory protection is that the banker must fulfil his statutory duty towards the true owner of the cheque and exercises due care in safeguarding the latter's interest,i.e. without negligence.Negligence can be of various types. It depends upon the circumstances of each case.



13.11 FURTHER READING

1) Banking Theory, Law and Practice by E. Gordon & K.Natarajan.
2) Banking Theory, Law and Practice by Dr. S Gurusamy.

13.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A banker who undertakes the task of collecting cheques and other instruments of credit from the drawee bank is called a 'collecting banker'.

Ans to Q No 2: If the collecting banker pays to the customer the amount of the cheque or credits such amount to his account and allows him to draw on it,before the amount of the cheque is actually realised from the drawee banker,the collecting banker is deemed to be its 'holder for value'.

Ans to Q No 3: The banker who receives the amount of a cheque for which the customer has no valid title is held liable for the unlawful act legally termed as conversion by the collecting banker.

Ans to Q No 4: The underlying principle of 'conversion' is that a rightful owner of the goods can recover the same from anyone who takes it without authority and in whose hands it can be traced.

Ans to Q No 5: Ans: A collecting banker is given protection under Section 131 of the Negotiable Instruments Act,who receives payment of a crossed cheque or draft on behalf of his customer.



13.13 MODEL QUESTIONS

Q 1: Who is known as collecting banker?Discuss the duties of a collecting banker.

Q 2: State the precautions a collecting banker should take while collecting cheques.

Q 3: What are the conditions that must be satisfied before statutory protection available to a collecting banker in India?

Q 4: Under what circumstances a collecting banker can claim statutory protection under the Negotiable Instruments Act? Explain the position of collecting banker as-

a. A holder for value and

b. An agent of the customer

Q 5: Identify the circumstances under which a collecting banker is considered to be negligent in his duty?

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UNIT 14: BANK ADVANCES

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Consideration for Sound Lending

14.4 Different Forms of Advances

- 14.4.1 Loan
- 14.4.2 Cash Credit
- 14.4.3 Overdraft
- 14.4.4 Bill Discounting

14.5 Consortium Advances

14.6 Secured and Unsecured Advances

14.7 Let Us Sum Up

14.8 Further Reading

14.9 Answers to Cheek Your Progress

14.10 Model Questions

14.1 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.

14.2 INTRODUCTION

In the first unit we have discussed that the commercial banks accept deposits and also lend money in the form of loans and advances. Granting loans and advances is one of the primary functions of commercial banks. 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.

14.3 CONSIDERATIONS FOR SOUND LENDING

while advancing money the banker should consider the following points-

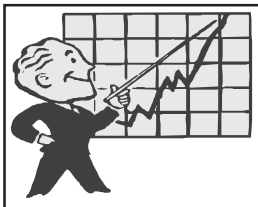
a) **Safety** – 'Safety' is the main principle of lending. Safety means that the borrower is in a position to repay the loan, along with interest. In order to ensure safety the banker should advance loans and advances only against tangible securities. Further, the character of the borrower, his capacity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

14.4 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:

14.4.1 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

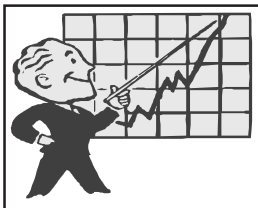
Following are the advantages of loan

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.

14.4.2 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) .....

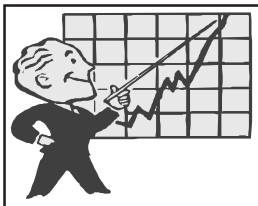
ii) .....

14.4.3 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?

.....

14.4.4 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.

14.5 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.

14.6 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.

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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.



14.7 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.



14.8 FURTHER READING

1) M.L.Tannan, revised by C.R. Datta & S.K. Kataria : Banking Law and Practice, Wadhwa & Company, Nagpur.
2) Sundharam & Varshney : Banking Theory, Law & Practie - Sultan Chand & Sons.
3) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.
4) R.R. Paul : Money Banking and International Trade, Kalyani Publication.
5) S.K. Maheshwari S.N. Maheshwari: Banking Law and Practice, Kalyani Publication.

14.9 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.

14.10 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.

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UNIT 15 : SECURITY FOR ADVANCES

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning of Pledge, Hypothecation, and Mortgage

15.4 Difference between Pledge, Hypothecation, and Mortgage at a glance

15.5 Meaning of Advances against Goods

15.6 Meaning of Advances against Document of Title to Goods

- 15.6.1 Important Documents of Title to Goods

15.7 Meaning and Definition of Advances against Stock Exchange Securities

- 15.7.1 Conditions of Banks at the time of advances against Securities
- 15.7.2 The following are the drawbacks of advancing money against stock- exchange securities
- 15.7.3 Precautions to be taken

15.8 Meaning of Advances against Life Insurance policies

- 15.8.1 Purpose of Life Insurance Policy as a Security
- 15.8.2 Advantages of Life Insurance Policies as Security
- 15.8.3 Disadvantages of Life Insurance Policy as a Security
- 15.8.4 Precautions to be taken by the Banker

15.9 Meaning of Advances against Fixed Deposit Receipts

- 15.9.1 Precautions

15.10 Meaning of Assignments

- 15.10.1 Assignment - important features
- 15.10.2 Types of Assignment

15.11 Meaning of Loans without collateral securities

- 15.11.1 Types of Unsecured Loans
- 15.11.2 Special Considerations for an Unsecured Loan

15.12 Meaning of Guarantees

15.12.1 Essential Features of a Contract of Guarantee
15.13 Let Us Sum Up
15.14 Further Reading
15.15 Answers To Check Your Progress
15.16 Model Questions

15.1 LEARNING OBJECTIVES

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

- explain the meaning of security for advances
- state the meaning and difference of pledge, hypothecation, and mortgage
- explain the important features of pledge, hypothecation, and mortgage
- explain the meaning of advances against goods
- explain the meaning of unsecured loan, guarantees and its important features and precautionary measures.

15.2 INTRODUCTION

Financer or Banks are required to be careful in handling various loans and advances, otherwise financer or banks may be exposed to various risks. Non observance of proper control, monitoring, and checking might result in the financer's or bank's financial loss and sometimes even affects the reputation as well. In this regard understanding the importance of legal terms i.e., Charges like pledge, hypothecation and mortgage are important. Financer or banks lend money to the borrowers against various kinds of securities. Financer or Banks should ensure that they obtain securities to protect the bank in case of default by the borrower. To protect the interests of the financer or banks, the securities obtained by financer should have marketable value and also such security can be legally enforceable.

The financer gets certain rights in the tangible assets over which a charge is created. There are several modes of creating a charge which are discussed in this unit.

15.3 MEANING OF PLEDGE, HYPOTHECATION, AND MORTGAGE

1. Pledge: Pledge is used when the lender (pledgee) takes actual possession of assets (i.e. certificates, goods). Such securities or goods are movable securities. In this case the pledgee retains the possession of the goods until the pledgor (i.e. borrower) repays the entire debt amount. In case there is default by the borrower, the pledgee has a right to sell the goods in his possession and adjust its proceeds towards the amount due (i.e. principal and interest amount). Some examples of pledge are Gold /Jewellery Loans, Advance against goods,/ stock, Advances against National Saving Certificates etc.

Section 172 of the Indian Contract Act defines pledge as "The bailment of goods as a security for the payment of a debt or performance of a promise" The bailor in this case is called a Pawnor or the Pledger and the bailee is called Pawnee or the Pledgee.

Important features of pledge

(i) The person, whose goods are bailed is called pawnor or pledger, and to whom the goods are pledged as pawnee or pledgee.

(ii) Ownership of the property is retained by the pledger, which is subject only to the qualified interest which passes to the pledgee by the bailment.

(iii) The essential feature of a pledge is the actual or constructive delivery of the goods to the pledgee. By constructive delivery it is meant that there will be no physical transfer of goods from the custody of the pledger/ pawnor to the pledge/ pawnee. All that is required is that the goods must be placed in the possession of the pawnee or of any person authorized to hold them on his behalf.

(iv) The delivery of the goods may be 'physical' when goods are actually transferred and 'symbolic' as in the case of delivery of the key or 'constructive' as in the case of adornment.

(v) Pledge can be created only in the case of existing goods (and not on future goods) which are in the possession of the pledger himself.

(vi) Since the possession of goods is the important feature of pledge and therefore, pledge is lost when possession of the goods is lost.

(vii) An agreement of pledge also known as deed of pledge may be implied from the nature of the transaction or the circumstances of the case

(viii) To protect the interests of the concerned parties the agreement in writing should clearly indicate the terms and conditions.

2. **Hypothecation:** Hypothecation is used for creating charge against the security of movable assets, but here the possession of the security remains with the borrower itself. Thus, in case of default by the borrower, the lender (i.e. to whom the goods / security has been hypothecated) will have to first take possession of the security and then sell the same. The best example of this type of arrangement is Car Loans. In this case Car / Vehicle remain with the borrower but the same is hypothecated to the bank / financer. In case the borrower defaults, banks take possession of the vehicle after giving notice and then sell the same and credit the proceeds to the loan account. Other examples of this hypothecation are loans against stock and debtors. Under the Secruitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, hypothecation is defined as "a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance, and includes floating charge and crystallization into fixed charge on movable property".

Important features of Hypothecation

1. The charge hypothecation is applicable to movable assets.
2. The ownership and possession are held by the borrower of the assets (security).

3. The document (hypothecation agreement) provides for a covenant, whereby the borrower agrees to give possession of the goods (movable assets) when called upon to do so by the creditor. Upon taking over the possession of goods, the charge is treated as pledge.

3. Mortgage: Mortgage is used for creating charge against immovable property which includes land, buildings or anything that is attached to the earth or permanently fastened to anything attached to the earth (However, it does not include growing crops or grass as they can be easily detached from the earth). The best example when mortgage is created is when someone takes a Housing Loan / Home Loan. In this case house is mortgaged in favour of the bank / financer but remains in possession of the borrower, which he uses for himself or even may give on rent. Under Section 58 of the "Transfer of Property Act 1882" mortgage is the transfer of an interest in specific immovable property for the purpose of securing payment of money advanced by way of loan.

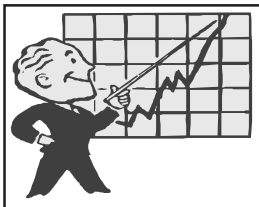
Important features of Mortgage

(i) The mortgagee has no power to sell the property without the intervention of the court. In case there is shortfall in the amount recovered even after sale of the mortgaged property the mortgagor continues to be personally liable for the shortfall.

(ii) The mortgagee has no right to get any payments out of the rents and produce of the mortgaged property

(iii) The mortgagee is not put in possession of the property

(iv) Registration is mandatory if the principal amount secured is Rs. 100 and above.



CHECK YOUR PROGRESS

Q 1: Define Pledge?

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15.4 DIFFERENCE BETWEEN PLEDGE, HYPOTHECATION & MORTGAGE

Difference between Pledge, Hypothecation and Mortgage at a Glance:

Basis	Pledge	Hypothecation	Mortgage
Type of Security	Movable.	Movable.	Immovable.
Possession of the security	Remains with lender(pledgee).	Remains with Borrower.	Usually Remains with Borrower.
Examples of Loan where used	Gold Loan, Advance against NSCs, Advance against goods (also given under hypothecation).	Car/Vehilce Loans, Advance against stock and debtors.	Housing Loans.

15.5 ADVANCES AGAINST GOODS

Advances sanctioned by scheduled banks in India are secured by goods and commodities broadly divided into four main heads as follows:

(i) Food articles,

(ii) Industrial raw materials,

(iii) Plantation products, and

(iv) Manufactures and materials.

These advances meet the needs of working capital of a large number of business and industrial concerns. In fact, such advances are essential for all trading and commercial activities in the country, i.e., for storing the agricultural output, the industrial raw materials and the finished products from the time of their harvest or production till their final consumption. An evaluation of goods and commodities as security to the banker reveals the following merits and demerits:

1. **Safety:** Goods and commodities are tangible assets and provide better security to the banker as compared to the unsecured advances, including guaranteed advances and discounting of bills. If the debtor fails to repay the loan, the banker realises his dues by selling the pledged

goods and may recover the balance, if any, from other property of the debtor. Even as a secured creditor the banker is not fully safe from the risks of fraud or dishonesty on the part of the borrower. With utmost precautions on his part, he cannot verify the quantity and quality of the goods pledged to him. It is practically impossible for the bank manager or the godown-keeper to check and vouch the correctness of the contents of each and every bag, container or package stored in a godown. A dishonest borrower can deceive the banker by pledging goods which do not tally with the description given by him in the documents.

2. **Price Stability:** As regards the price of the goods and commodities, mixed behavior is experienced. The prices of the goods which are necessaries of life are relatively stable over a short period, though not necessarily over a long period. But wide variation in the prices of luxury goods take place due to changes in demand, fashions and tastes of the people. Bankers are generally reluctant to accept the commodities the prices of which are uncertain and fluctuate too widely and frequently. The problem of valuation of stocks pledged is not a difficult one, as daily market quotations are published in the papers and more quotations can be had from reliable traders and brokers.
3. **Easy Marketability:** Goods and commodities can be liquidated more easily than fixed assets like land and buildings or plants and equipments. Some commodities like wheat, sugar and cotton enjoy ready market while the demand for manufactured articles of seasonal utility or of durable consumer goods is not constant throughout the year. The banker is naturally inclined to accept the commodities having regular and steady demand and wide market.
4. **Shorter duration of Advances:** As the goods and commodities decay or deteriorate in quality over a period of time, bankers lend against them for shorter periods only. In practice however, the advances continue even after the normal period is over and are renewed for another period. Such loans are called 'rolled over loans'. Advances against documents of title to goods like the bill of lading or railway

receipt are self liquidating in nature because as soon as the documents are handed over to the consignee against payment or acceptance of the bill of exchange the banker gets back the funds lent by him.

15.6 ADVANCES AGAINST DOCUMENTS OF TITLE TO GOODS

A document of title to goods is a document used in the ordinary course of business as a proof of the possession or control of goods. It authorizes, either by endorsement or by delivery, the processor of the document to transfer or receive the goods represented by it (Sec. 2 (4) of the Sale of Goods Act. 1930). Thus, a document of title to goods represents actual goods in the possession of somebody else. It confers on the purchaser the right to receive the goods and to transfer such right to any other person by mere delivery or by endorsement and delivery.

As per the Section 2(4) of the Sale of Goods Act, 1930, a document of title to goods is a document used in the ordinary course of business as a proof of possession or control of goods authorising or purporting to authorize either, by endorsement or delivery, the possessor of the documents, to transfer or receive the goods thereby represented.' Thus, the essential requisites of a document of title to goods are:

(i) The mere possession of the documents creates a right either by virtue of law or trade usage, to possess the goods represented by the documents.

(ii) Goods represented by the documents can be transferred by endorsement and/or delivery of the documents.

(iii) The transferee of the documents can take delivery of the goods in his own right.

(iv) Although they appear to be negotiable instruments, documents of title to goods are not negotiable instruments. The title of bona fide transferee for value can be affected by defects in the title of transferor. They may be called quasi-negotiable instruments.

15.6.1 Important Documents of Title to Goods

1. **Bill of Lading:** A Bill of Lading is a document issued by the shipping companies' acknowledgement the receipt of goods for carrying to a specified port. It also contains the conditions for such transportation of goods and full description of the goods, i.e., their markings and contents as declared by the consignor. The shipping company gives an undertaking to deliver the goods to the consignee or to his order in the same condition in which it has received, on payment of the freight and other charges due thereon. It is to be noted that a Bill of Lading is primafacie evidence of the fact that the packages, as specified therein, were put on board the ship but the shipping company is not responsible for the contents of the bags or the bales entrusted to it for transportation. It is therefore, essential for the banker to accept such documents from reliable and trustworthy parties only.

   Bills of Lading are issued in sets of three, duly signed and bearing the mark 'original', 'duplicate', or 'triplicate', respectively. The shipping company delivers the goods on the presentation of any one of the three copies of the bills of lading, thus rendering the other two ineffective. It is therefore, essential for the banker or financer to demand all the three copies of the bill of lading duly endorsed, before an advance is made against it.

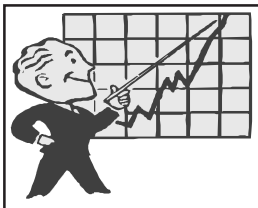
2. **Warehouse Receipts:** An important objective of promoting warehouse in the country has been to enable the owners of the commodities- agriculturists and traders - to acquire a convenient security in the form of warehouse receipts, which can be accepted as security by the banks, the Reserve Bank granted some concessions in respect of such advances in its selective credit control directives in the past. Most of the advances against warehouse receipts have been sanctioned to the traders.

3. **Railway Receipt:** Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned there in. It is a transferable but not a negotiable instrument. It can be transferred by endorsement and delivery. As the receipt is to be produced before the railway authorities to clear the goods at the destination, advances sought against such receipts are for very short periods. Generally, the consignor of the goods draws a bill of exchange or a hundi on the consignee for the amount of the goods consigned and discounts the bill/hundi with the banker. The Railway Receipt is enclosed with the bill which is called a documentary bill. The banker releases the Railway Receipt to the consignee against payment/acceptance of the bill.

4. **Trust Receipts:** The goods or the documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes the borrower wishes to get the security released before he actually repays the loan. In such cases, the banker may, at his discretion, allow the customer to get back the goods or documents and ask the latter to execute a Trust receipt. By signing such Receipt, the customer undertakes to receive the goods or the documents of title to goods in trust for the lender. The borrower promises to hold the goods or their sale proceeds as trustee for the banker and to pay the same to the latter as and when received.

   The legal position of the Trust receipt from the banker's point of view, however, remains unsatisfactory. As regards the ineffectiveness of a Trust Receipt as a security for the banker, the Banking Commission, 1972, opined that - "The present position seems to be that advances against trust receipts do not create any trust, that goods released against trust receipt would be affected by the reputed ownership clause under the

insolvency laws in India, that the borrower may validly create unauthorized pledge of the documents of title to goods released to him under a Trust receipt and that for any wrongful dealing with the goods it may not be possible to prosecute the borrower."



CHECK YOUR PROGRESS

Q 2: What is a document of title to goods?

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Q 3: Give two examples of document of title to goods

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15.7 ADVANCES AGAINST STOCK EXCHANGE SECURITIES

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

a) Securities issued by the Central and State Governments.

b) Securities issued by semi- Government institutions like the Port Trusts, Improvement Trusts, etc.

c) Shares of Joint Stock Companies.

d) Debentures or Bonds of Joint Stock Companies.

15.7.1 Conditions of Banks at the time of advances against Securities

Banks may grant advances against the Stock Exchange Securities like, shares, debentures or bonds to individuals subject to the following conditions:

(i) Purpose of the Loan: Loan against shares, debentures and bonds may be granted to individuals to meet contingencies

and personal needs or for subscribing to new or rights issues of shares / debentures / bonds or for purchase in the secondary market, against the security of shares / debentures / bonds held by the individual.

(ii) **Amount of advance:** Loans against the security of shares, debentures and bonds should not exceed the limit of Rupees ten lakhs per individual if the securities are held in physical form and Rupees twenty lakhs per individual if the securities are held in dematerialised form. Such loans are meant for genuine individual investors, and banks should not support collusive action by a large group of individuals belonging to the same corporate or their inter-connected entities to take multiple loans in order to support particular scrip or stock-broking activities of the connected firms. Such finance should be reckoned as an exposure to capital market.

(iii) **Margin:** Banks should maintain a minimum margin of 50 percent of the market value of equity shares / convertible debentures held in physical form. In the case of shares / convertible debentures held in dematerialised form, a minimum margin of 25 percent should be maintained. These are minimum margin stipulations and banks may stipulate higher margins for shares whether held in physical form or dematerialised form. The margin requirements for advances against preference shares / non-convertible debentures and bonds may be determined by the banks themselves.

(iv) **Lending Policy:** Each bank should formulate with the approval of their Board of Directors a Loan Policy for grant of advances to individuals against shares / debentures / bonds keeping in view the RBI guidelines. Banks should obtain a declaration from the borrower indicating the extent of loans availed of by him from other banks as input for credit evaluation. It would also be necessary to ensure that such accommodation from different banks is not obtained against shares of a single company or a

group of companies. As a prudential measure, each bank may also consider laying down appropriate aggregate sub-limits of such advances.

15.7.2 The following are the drawbacks of advancing money against stock- exchange securities

(i) **Liability to pay in case of partly-up shares :** In case partly paid shares have been transferred in the banker's name and the company makes a call, the banker will have to make payment of such a call.

(ii) **Company's lien:** The articles of the companies generally provide that the company will have a right of lien on its shares for any call due on them or any money due by the shareholder to the company. However, his right of lien will not be available to the company against such debts which the company might have contracted after receipt of notice of pledge from the bank. But in case the bank fails to give notice or there are already large debts outstanding against the debtor in favour of the company, the banker's interests will be adversely affected.

(iii) **Forgery:** The bank may suffer loss on account of forgery committed by the borrower, e.g.. the transferor's signatures may have been forged or the original as well as duplicate copy of the same certificate might have been pledged with different bankers by the borrower. In case the shares have been registered in the name of the bank on the basis of forged signatures of the transferor, the banker is liable to the company for any loss suffered by it. This liability continues even in cases where the banker (the transferee) has subsequently sold shares.

(iv) **Fluctuations in prices:** The bank may have to suffer loss in case there are violent fluctuations in the value of the securities and it has not kept adequate margin.

15.7.3 Precautions to be taken

The drawbacks listed above are mainly in respect of corporate securities. The bank can protect its interest if takes the following precautions:

1. **Selection of the securities:** The task of the selection of corporate securities is profaned by the Head Office of the bank. A list of such securities is prepared and sent to every branch of the bank. The bank should not grant loan on a corporate security which is not included in the list unless the consent of the Head Office is obtained. While selecting such securities for inclusion in the list, the following factors are considered:
   - **(a) Nature of company's business:** The type of business activity, its importance in the national economy, its future prospects and the company's position in that industry, etc., are factors which should be examined. In case they are all favourable, the compat1y's security can be rated high.
   - **(b) Company's management:** In case the company is being managed by persons of proven competence, integrity and honesty, the banker can take it as a plus point for inclusion of the security in its list.
   - **(c) Past-working results.** The past performance of the company in tenns of production, sales, profits, dividends, etc., can be suitable basis for performance of the company in future. The various accounting ratios based on previous income statements and balance sheets will help the bank in ascertaining the financial position of the company.
   - **(d) Market trends in values of the shares of the company.** The ends in value of the shares of the company are indicators of the value of company's shares in future. The bank can also judge about the stability in the values of the company's shares on the basis of such trends.

2. Valuation of securities: ll1e valuation of corporate securities dealt on stock exchange can be done on the basis of daily stock exchange quotations. However, the bank should also calculate the break-up value' of the shares. While valuing these securities in case they are quoted cum-dividend or com-interest, the amount of dividend or interest included in the price should be subtracted.

3. Creation or charge: The banker should finally get the securities charged in its favour. Such charge can be created in either of the two ways :

(i) By giving a legal title

(ii) By creating an equitable title.

i) Legal Title. In case of legal title the securities transferred by the borrower to the bank in its name. The name of the banks or its nominee replaces the name of the borrower in the company's records.

ii) Equitable. In case of an equitable charge the borrower transfers the equitable title to the securities in favour of the bank by depositing the securities with it. The securities continue to stand in the borrower's name in company's records. The equitable charge may be created by any of the following methods :

(a) By mere deposit of securities: Mere deposit of securities with the banker with the intention of creating a charge in favour of the bank is riot very , popular with the banks on account of likely complications that may arise in , the absence of any written document.

(b) By memorandum of deposit: The bank may obtain from the borrower a memorandum stating that:

(i) The securities mentioned therein have been deposited by the borrower as security for the loan obtained from the bank.

(ii) The bank will be entitled to sell the securities in the event of failure of the borrower to make repayment as per terms of agreement.

(iii) The banker will be entitled to debit the borrower's account with any, amount that it might have to pay towards payment of call on securities (in the event of their being partly paid-up), The memorandum duly signed by the borrower will be handed over by him to the bank together with the securities.

(c) By blank transfer: The customer may be required to deposit with the bank together with blank transfer forms duly signed by him. In case of blank transfer the name of the transferee is not filled in the form. The advantage of such a transfer is that the bank may at any time fill its own name or that of any I other person to whom it has sold the securities for recovering the loan. The bank or such other person can get legal title to the securities by sending the transfer form duly filled in together with securities to the company for registration.

(d) By power of attorney: The bank may get executed from their customers in respect of securities deposited, special powers of attorney either in its own favour or in favour of its nominees. The power of attorney will empower the bank or its no1ninees to deal in the securities so deposited on behalf of the customers. The power of attorney will protect the banker from all possible risks. The second and third methods of creating equitable charge are more popular with the banks.

Risks in case or equitable charge

(i) Existence of prior equitable title: An equitable charge becomes defective by a prior equitable charge or a subsequent legal charge.

(ii) Company's right of lien: In case the articles give the company right of lien on its shares, it will have an adverse effect on banker's right of equitable charge.

(iii) Absence of information to the bank: Since the borrower continues to be the registered holder of shares, he gets every information regarding issue of bonus shares, company's meetings, issue of right shares etc. The borrower may get bonus shares and may sell them directly. Thus, the banker's security is reduced. Precautions to be taken by the banker in case of an equitable charge.

15.8 ADVANCES AGAINST LIFE INSURANCE POLICIES

A Life Insurance Policy is a contract between the insured and the insurer wherein the latter promises to pay a specified amount after the expiry of a certain period or on the occurrence of death of the assured. In India, the Life Insurance Corporation of India is the only Institution engaged in the business of life insurance. It has issued several kinds of life insurance policies; to suit the needs of different classes of people, e.g. endowment policies, multipurpose policies, fixed term marriage endowment policies, educational policies, etc. The primary objective of the insured in a large number of cases happens to make a provision for his old age or to secure protection to his dependants in case of his untimely death.

15.8.1 Purpose of Life Insurance Policy as a Security

A life insurance policy is taken for two purposes:

(i) It is a source of income for the dependents of the assured in case of his death.

(ii) It is an ideal form of saving since along with income tax deduction on the premium, paid loans can be raised on the policies in times of need.

15.8.2 Advantages of Life Insurance Policies as Security

(i) Life insurance business being highly regulated and permitted only to companies having sound financial health, the banker

need not doubt the realisation of the policies, which will be done without any difficulty, if the policy and the claim are in order.

(ii) The assignment of the policy in favour of the banker requires very little formalities and the banker obtains a perfect title.

(iii) The longer the period for which the policy has been in force, the greater the surrender value. It is also useful as an additional security because, in the event of the borrower's death, the debt is easily liquidated from the proceeds of the policy.

(iv) The security can be realized immediately on the borrower's default of payment by surrendering the policy to the insurance company.

(v) The policy is a tangible security and is in the custody of the bank. The banker only has to ensure that regular payment of premiums is made.

15.8.3 Disadvantages of Life Insurance Policy as a Security

(i) If the premium is not paid regularly, the policy lapses and reviving the policy is complicated.

(ii) Insurance contracts being contracts of utmost good faith, any misrepresentation or non-disclosure of any particulars by the assured would make the policy void and enable the insurer to avoid the contract.

(iii) The person (proposer) who has obtained the policy must have an insurable interest in the life of the assured or the contract is void.

(iv) The policy may contain special clauses, which may restrict the liability of the insurer.

(v) When the banker accepts a policy coming under Married Women Property Act he must ensure that all the parties sign in the bank's form of assignment.

(vi) There is facility to obtain the duplicate policy if the original is lost. This can be misused by persons by obtaining duplicate policies. Banker should therefore, verify that no duplicate policy has been issued and there are no encumbrances on the policy.

15.8.4 Precautions to be taken by the Banker

(i) The policy must be assigned in favour of the bank and should be sent directly to the insurance company for registration and ensured that only authorized office of Insurance Company has noted assignment.

(ii) The bank should see that the age of the assured is admitted.

(iii) The banker should assured that there should be existence of Insurable Interest taken by a person on his own life or on the life of any other person.

(iv) The banker should ensure the regular payment of premium.

15.9 ADVANCES AGAINST FIXED DEPOSIT RECEIPTS

When money deposited by a customer is not repayable on demand and is payable on the expiry of a specified period from the date of deposit such a deposit is called a 'Fixed Deposit'. The banker evidences a deposit by issuing a receipt known as fixed deposit receipt. Interest, is paid at regular intervals at a specified rate on such deposits. Banks usually permit depositors to borrow against the deposit. This security is certainly the most valuable, as the money represented by the receipt is already with the bank and there is no problem of valuation or enquiring the title, or the problem of storage and costs associated with storage.

If the Customer of the bank is in urgent need of money, they may take an advance from the banker on the security of the fixed deposit receipt or alternatively they may request the banker for the repayment of the deposit before its due date. While making advances against fixed deposit receipts, the banker should observe the following precautions:

15.9.1 Precautions

(i) The banker should grant the advance only to the person in whose name the money is deposited. Banker should not advance against fixed deposit receipts of other banks. This is because the banker who has received the deposit will have a general lien over such monies. Even if the lending bank gives notice to the bank, which has received the deposit, the latter may even refuse to register the lien in favour of the lending bank.

(ii) If, the deposit is in joint names the request for loan must come from all of them.

(iii) When the deposit receipt is taken as security, the banker should ensure that all the depositors duly discharge it on the back of the instrument, after affixing the appropriate revenue stamp. In addition to this, the banker should obtain a letter of appropriation which authorizes the banker to appropriate the amount of the deposit on maturity or earlier towards the loan amount.

(iv) After granting the advance, the banker must note his lien in the fixed deposit register to avoid payment by mistake and the lien, must also be noted on the receipt itself.

(v) Advance should preferably not be made against fixed deposit receipt in the name of a minor, unless a declaration is taken from guardian, that loan will be utilized for benefit of the minor.

(vi) Where the money is being advanced against the fixed deposit receipt issued by another branch, the FDR duly discharged must be sent to the branch, where such money is deposited, for the following purposes:

  (a) To verify the specimen signature of the depositor.

  (b) To ensure that no prior lien exists on the fixed deposit receipt.

  (c) To mark lien on the FDR and the FDR register, in favour of branch advancing money.

(vii) Sometimes, a person may approach for advances by offering the fixed deposit receipts held by third parties as security. In such a case, the fixed deposit receipt must be duly discharged, by the third party, i.e., FD holder and he should declare in writing the bank's right to hold the deposit receipt as security, and also to adjust the deposit amount towards the loan account on maturity or on default in repayment of installment if any.

15.10 ASSIGNMENT

Assignment is a type of charge on certain securities offered to a creditor. It is transfer of right, for a property or debt. Two persons are involved in assignment, the person who transfers his right is called the assignor and the beneficiary is called assignee. For example when a bank gives loan to a borrower against his book debts (future receivables), two parties involved are (i) the borrower (debtor) and the banker (creditor). The borrower/debtor, who is called the assignor, transfers his rights of receiving the funds from his customers. The banker (lender/creditor) to whom the rights are transferred is called as the assignee.

One example of assignment is 'transfer by the holder of a life insurance policy (the assignor) of the benefits or proceeds of the policy to a lender (the assignee), as a collateral for a loan'. In such case in the event of the death of the assignor, the assignee is paid first and the balance (if any) is paid to the policy's beneficiary. However, insurance policies other than life insurance may not be used for this purpose.

For example, if A owes B INR. 500 and B owes C a like amount, B has the right to receive from A and is under liability to pay C. B can ask A to pay directly to C and if A accepts, that will be an assignment of B's right to C. Considering the same situation if instead of transferring such a right B would have transferred any of his obligation in the matter, it would have amounted to novation.

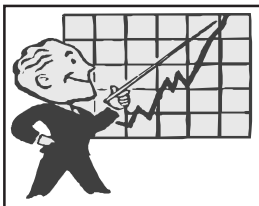
15.10.1 Assignment - important features

1. Section 130 of the Transfer of Property Act, states that the transfer of an actionable claim can be affected only by the execution of an instrument in writing signed by the transferor or by his duly authorized agent.
2. An actionable claim is defined as a claim to any debt other than a debt secured by {(i) mortgage of immovable property or (ii) hypothecation or (iii) pledge of movable property or (iv) any beneficial interest in any movable property} not in the possession of the claimant.
3. A borrower may assign any of the following items to secure a loan viz., (i) book debts (ii) life insurance policies (iii) money due from Government department.
4. An assignment can be absolute or by way of security
5. An assignment may be a legal or equitable assignment
6. As regards of book debts, the assignor informs his debtor, in writing, about the details of the assignee's full communication details like name address e mail and telephone numbers etc., to enable him to pay the amount to the assignee directly until further instructions from his client.
   (i) In the case of a life insurance policy, is assigned by an endorsement on the back of the policy or by a special deed of assignment. Notice of such assignment must be given to the insurer by the assignor or assignee, to enable the life insurance company to register the assignment in the records of the company records and act as per instructions.

15.10.2 Types of Assignment

Assignment may be either (i) a legal assignment, or (ii) an equitable assignment. A legal assignment is an absolute transfer of actionable claim and must be in writing, signed by the assignor. The latter informs his debtor also in writing, intimating the assignee's

name and address. The assignee also serves a notice on the debtor of the assignor and seeks a confirmation of the balance so assigned. If all these requirements are not fulfilled the assignment is called an equitable assignment.



CHECK YOUR PROGRESS

Q 4: What mean by assignment?

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15.11 LOAN WITHOUT COLLATERAL SECURITIES

Loans without Collateral Securities or an unsecured loan is a loan that is issued and supported only by the borrower's creditworthiness, rather than by any type of collateral. Unsecured loans-sometimes referred to as Signature loans or personal loans-are approved without the use of property or other assets as Collateral. The terms of such loans, including approval and receipt, are therefore most often contingent on the borrower's credit score. Typically, borrowers must have high credit score to be approved for certain unsecured loans. A credit score is a numerical representation of a borrower's ability to pay back debt and reflects a consumer's creditworthiness based on their credit history.

How an Unsecured Loan Works - An unsecured loan stands in contrast to a secured loan in which a borrower pledges some type of asset as collateral for the loan. The pledged assets increase the lender's "security" for providing the loan. Examples of secured loans include mortgages or car loans. On the other hand, unsecured loans are riskier for lenders, and as a result, typically come with higher interest rates. Unsecured loans also require higher credit scores than secured loans. In some instances, lenders will allow loan applicants with insufficient credit to provide a Co-signer who can take on the legal obligation to fulfill a debt should the borrower default. Default occurs when a borrower fails to repay the interest and principal payments of a loan or debt.

Elements of loans without collateral securities:

- An unsecured loan is a loan that's supported only by the borrower's creditworthiness, rather than by any type of collateral.
- Unsecured loans are sometimes referred to as personal or signature loans since they don't use property or other assets as collateral.
- Unsecured loans are riskier for lenders than secured loans resulting in higher interest rates and require higher credit scores.

15.11.1 Types of Unsecured Loans

Unsecured loans include credit cards, student loans, and personal loans-all of which can be revolving or term loans.

- A Revolving Loan is a loan that has a credit limit that can be spent, repaid, and spent again. Examples of revolving unsecured loans include credit cards and personal lines of credit.
- A Term Loan, in contrast, is a loan that the borrower repays in equal installments until the loan is paid off at the end of its term. While these types of loans are often affiliated with secured loans, there are also unsecured term loans.
- A Consolidation Loan to pay off credit cards or a signature loan from a bank would be considered an unsecured term loan.

15.11.2 Special Considerations for an Unsecured Loan

If a borrower defaults on a secured loan, the lender can repossess the collateral to recoup the losses. In contrast, if a borrower defaults on an unsecured loan, the lender cannot claim any property. However, the lender can take other actions, such as commissioning a collection agency to collect the debt or taking the borrower to court. If the court rules in the lender's favour, than the borrower's liable to pay the unpaid amounts. Also, a lien may be placed on the borrower's home, or the borrower may be otherwise ordered to pay the debt.

15.12 GUARANTEES

Contract of guarantee have special significance in the business of banking as a means to ensure safety of funds lent to the customers. The safety of such funds is primarily ensured by securing a charge over the tangible assets owned by the borrower and /or by the personal security of the latter. But in case the borrower is unable to provide the security of tangible assets or the value of the latter falls below the amount of the loan and the borrower's personal security is not considered sufficient, an additional security is sought by the banker in the form of a 'guarantee' given by a third person. A guarantee is, in fact, the personal security of the third person, who must command the confidence of the banker.

A contract of guarantee is a specific contract and is governed by the provision of the Indian Contract Act, 1872. Section 126 defines a contract of guarantee as a "contract to perform the promise or discharge the liability of a third person in case of his default." The person who undertakes the above obligation to discharge the liability of a third person is called the guarantor or the surety. The person in respect of whose default the guarantee is given is called the 'principal debtor' and the person to whom the guarantee is given is called the 'creditor'.

15.12.1 Essential Features of a Contract of Guarantee

1. A contract of guarantee may be either oral or written (Sec. 126).
2. Sometimes a contract of guarantee is implied also from special circumstances.
3. A guarantee may be either a) a specific guarantee, or b) a continuing guarantee (Sec. 129 & 130).
4. Consideration- A contract of guarantee, like any other valid contract, must have 'consideration' (Sec 127).
5. Effect of Misrepresentation or Concealment of Material Facts (Sec. 142 &143).



15.13 LET US SUM UP

In this unit we have discussed the following points :

- The meaning of Security for Advances.
- The meaning and difference of Pledge, Hypothecation, and Mortgage under Indian law.
- Discuss the various features of Pledge, Hypothecation, and Mortgage
- The meaning of advances against goods and process of advance against goods.
- The meaning of Advances against document of title to goods and important documents of title to goods.
- Methods of advances against Stock Exchange securities and critically examine the advances against securities.
- The meaning of Advances against Life Insurance policies and process of advancing.
- Arguments in favour and in against of advances against Life Insurance policies.
- The meaning and precautionary measures of advances against Fixed deposit receipts.
- The meaning of assignments, its important features and precautionary measures.
- Meaning of unsecured loan, Forms of unsecured loan, special consideration against unsecured loan.
- Meaning of guarantees, essential feature of contract of guarantee.



15.14 FURTHER READING

1) M.L.Tannan, revised by : Banking Law and Practice, Wadhwa & Company, Nagpur C.R. Datta & S.K. Kataria.

2) A.B. Srivastava and : Seth's Banking Law, Law Publisher's India (P) Limited K. Elumalai.

3) R.K. Gupta : BANKING Law and Practice in 3 Vols. Modern Law Publications.

4) Prof. Clifford Gomez : Banking and Finance - Theory, Law and Practice, PHI Learning Private Limited.

5) Sundharam & Varshney : Banking Theory, Law & Practice - Sultan Chand & Sons.

6) J.M. Holden : The Law and Practice of Banking, Universal Law Publishing.

15.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Pledge is "The bailment of goods as a security for the payment of a debt or performance of a promise".

Ans to Q No 2: A document of title to goods is a document used in the ordinary course of business as a proof of the possession or control of goods.

Ans to Q No 3: Two examples of document of title to goods are-Bill of Lading, Dock Warrants.

Ans to Q No 4: Assignment is a type of charge on certain securities offered to a creditor. It is transfer of right, for a property or debt.

15.16 MODEL QUESTIONS

Q 1: Briefly justify the meaning of security for advances.

Q 2: What do you know about pledge and what are its features?

Q 3: What do you understand about hypothecation?

Q 4: Explain the meaning of Mortgage? What are the elements of Mortgage?

Q 5: Discuss the difference between Pledge, Hypothecation and Mortgage.

Q 6: Explain the process of advances against goods.

Q 7: Discuss the meaning of advances against document of title to goods.

Q 8: Discuss briefly the various document used as document of title to goods.

Q 9: Critically examine the advances against Stock Exchange securities and its process.

Q 10: Discuss the process of Advances against Life Insurance policies.

Q 11: State the arguments in favour of and in against of advances against Life Insurance policies.

Q 12: What are the precautionary measures taken by banks at the time of advances against Fixed deposit receipts?

Q 13: What is Assignment? Discuss the objectives of assignment.

Q 14: What are the precautionary measures taken by banks at the time of advances against unsecured loan or loan without collateral securities?

Q 15: Discuss the meaning of guarantees and its important features.

Q 16: What are the elements of contract at the time of advances against guarantees?

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2) Banking Theory, Law and Practice by E. Gordon & K.Natarajan.
3) Banking Theory, Law and Practice by Dr. S Gurusamy.
4) Essentials of E-commerce Technology, - V. Rajaraman, PHI.
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Course Code:

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Krishna Kanta Handiqui State Open University
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Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so
quality of self learning materials in future. Please respond to the following statements by tickin
feel most reflect your opinion. After completion of the additional comments, please detach the p
the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
Housefed Complex, Dispur, Guwahati- 781006
(E-mail id: ciqa@kkhsou.in)

1. Approximately how many hours did you spend for studying the units in the course?
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit			
II.	The units of the SLM could satisfy my academic needs and expectations			
III.	The Unit writers have excellent knowledge about the course contents			
IV.	Language and contents of the units were presented at a level which I could readily understand			
V.	Ample opportunity for participation in the activities provided in the units			
VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity			
VII.	Quality of content is engaging, relevant, and up-to-date			
VIII.	The self check questions are very helpful			
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot			

Additional Comments: *(Please feel free to provide your open comments)*

1. Which aspects of the SLM, according to you, worked well?

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2. What sort of changes/improvements do you feel KKHSOU could implement to improve of the SLM?

Thank you for taking the time to complete thi

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