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BANKING THEORY, LAW AND PRACTICE

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B.Com.,

Banking Theory, Law and Practice

Syllabus

Block - I

Banking systems - Branch banking versus Unit Banking and other banking systems - Deposit Banking versus Commercial Banking - Industrial Banking versus Development Banking - Commercial Bank functions - Creation of credit by Commercial Banks - Stature and functions of a Central Bank - Methods of Credit Control - Quantitative and qualitative methods.

Block - II

Structure and characteristics of the banking system in India - Banking sector reforms - Reserve Bank of India - Organisation, functions - Salient features of the Banking Regulation Act 1949.

Block - III

Definition of banker and customer - Relationship between banker and customer - Obligation to honour cheques - Banker's lien - Opening of Accounts - Special types of customers - Precautions to be taken - Types of Deposits - Bank Pass Book.

Block - IV

Cheques - Essentials of a valid cheques - Crossing, Marking and Endorsement of cheques - Holder and Holder in due course - Payment of cheques - Statutory protection to paying banker - Refusal of payment cheques - Collection of cheques - Statutory protection to the collecting banker.

Block - V

Loans and advances by commercial banks - Cash credit, Over Draft and Loans secured and unsecured - Modes of creating charges - Lien, pledge, Hypothecation and Advance against documents of title to goods, stock exchange securities, Mutual funds, Life insurance policies, Real estate, fixed deposit receipts, Book debts and supply bills - Precautions to be taken Purchase and Discounting of bills.

SCHEME OF LESSONS

		Page No.
Block I	**Banking Systems**	
Unit - 1	Banking Systems	2-13
Unit - 2	Commercial Bank Functions	14-32
Unit - 3	Stature and functions of a Central Bank	33-40
Unit - 4	Methods of Credit Control	41-60
Block II	**Structure of Banking System**	
Unit - 5	Structure and Characteristics of Banking System in India	62-76
Unit - 6	Reserve Bank of India	77-92
Unit - 7	Banking Regulation Act of 1949	93-117
Block III	**Banker and Customer**	
Unit - 8	Banker and Customer	119-134
Unit - 9	Types of Deposits	135-154
Unit - 10	Special Types of Customers	155-171
Block IV	**Cheques**	
Unit - 11	Essentials of a valid cheque	173-178
Unit - 12	Crossing of cheques	179-187
Unit - 13	Endorsement of cheques	188-197
Unit - 14	Holder and Holder in due course	198-207
Unit - 15	Payment of cheques	208-223
Unit - 16	Collection of cheques	224-231
Block V	**Loans and advances**	
Unit - 17	Loans and advances by commercial banks	233-254
Unit - 18	Modes of creating charge	255-268
Unit - 19	Advances against securities	269-293
Unit - 20	Purchase and Discounting of Bills	294-308

BLOCK - I

BANKING SYSTEMS

Unit - 1 : Banking Systems

Unit - 2 : Commercial Bank Functions

Unit - 3 : Stature and functions of a Central Bank

Unit - 4 : Methods of Credit Control

Unit 1

BANKING SYSTEMS

STRUCTURE

Overview

Learning Objectives

1.1 Latest Development in Indian Banking System

1.2 Branch Banking Vs Unit Banking

1.3 Deposit Banking Vs Commercial Banking

1.4 Industrial Banking Vs Development Banking

1.5 Banking in the Indian Context

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

Banking is as old as the authentic history and origins of modern commercial banking are traceable to ancient times. The New Testament mentions about the activities of the money changers in the temples of Jerusalem. In accident Greece around 2000 BC the famous temples of Ephesus, Delphi and Olympia were used as depositors for peoples. Surplus funds and these temples were the centers of money lending transactions. The priests of these great temples acted as the financial agents until public confidence was destroyed by the spread of disbelief in the religion. In India, the ancient Hindu scriptures refer to the money lending activities in the vedic period. The banker in the Smriti period performed most of those functions which banks performs in modern times. Banks being an important financial intermediary was first established in 1770 - The Bank of Hindustan. Later Bank of Bengal, Bank of Bombay and Bank of Madras was established. These three banks were known as the Presidency Banks. After 1862 there was usually a mushroom growth of Joint stock Banks with limited liability. In 1967 the Government introduced the concept of "social control" in the field of Banking Industry. The scheme of social control was aimed at bringing some laudable changes in the management and credit policy of the commercial banks. The social control measures were considered not adequate to achieve the desired social and economic objectives, hence 14 major Indian Banks were nationalized on 14th July 1969. Eleven years after nationalization of 14 commercial banks the government on April 15, 1980 took over six scheduled commercial banks each with demand and time liabilities exceeding Rs.200 crores through an ordinance issued by the president.

LEARNING OBJECTIVES

This unit describes the latest development in Indian Banking System and:

- Branch Banking vs Unit Banking
- Deposit Banking vs Commercial Banking.

The unit also discusses banking in the Indian Context.

1.1 LATEST DEVELOPMENTS IN INDIAN BANKING SYSTEMS

1. **Nationalization of the Reserve Bank:** To make the Reserve Bank more effective, the Government of India nationalized it on 1st January 1949. It was hoped that this step would enable the Bank to render greater assistance in the speedy economic development of the country.

2. **Banking Regulation Act, 1949:** This Act was passed in March 1949, with a view to securing the effective control and regulation of banks in the country. Under this Act, the reserve Bank was given extensive powers to carry out the inspection of scheduled banks. Under these powers, the Reserve Bank could check the accounts of the scheduled banks at any time. Besides, under this Act, the scheduled banks could open new branches without the prior permission of the Reserve Bank. This Act made special provision to safeguard the interests of the depositors. This Act was amended later on in 1963.

3. **Encouragement to Amalgamation:** The Government of India took steps to encourage the amalgamation of the weaker and nonviable banks. The amalgamations of the banks not only put and end to inter bank competition but also raised the level of efficiency in the banks. Under this policy, a new bank, known as the Union Bank of India was established in 1950, as a result of the amalgamation of four banks in West Bengal. The Bharat Bank was merged with the Punjab National Bank in March 1951. Under the Reorganization Scheme of the State Bank of India, ten scheduled banks which were located in the former Indian States were merged into the State Bank of India as subsidiaries.

This trend towards amalgamation of Indian banks continues even today. Recently, the Lakshmi Commercial Bank was merged with the Canara Bank. Likewise, the New Bank of India (a sick bank) was merged with the Punjab National Bank in September 1993.

4. **Establishment of the State Bank of India:** The Imperial Bank of India was nationalized on 1st July 1955 and renamed as the State Bank of India. The main objective of the State Bank was to open new branches in the rural and backward areas of the country. Besides, this Bank was to give special help for the development of Cooperative Banks in the country. After 1955, the State Bank of India opened a large number of branches in rural and semi rural

areas in pursuance of its objective. The Bank, thus, recorded appreciable progress in the expansion of banking facilities in the country.

5. **Provision for Training in Banking:** The Reserve Bank of India had been devoting special attention for the past several years to the proper training of the officers and other ranks in the banking industry. With this objective in view, the scope of the activities of the Indian Institute of Bankers has been widened in recent years. Besides, the Reserve Bank has also set up a training college to impart instruction to the bank employees in the theory and practice of banking.

6. **Nationalization of Commercial Banks:** The Government of India nationalized on the 19th July, 1969, fourteen major commercial banks of the country. On 15th April 1980, the Government of India, through a Presidential Ordinance, nationalized six additional commercial banks in the Private Sector.

1.2 BRANCH BANKING VS UNIT BANKING

Economists generally distinguish between branch banking and unit banking systems. In the branch banking system, every bank, as a single legal entity having one board of directors and one group of shareholders, operates through a network of branches throughout the country. In England, for example, the tendency has been for banking services to be concentrated in the hands of a very small number of banks - the "Big Five" as they are called - each having a large number of branches all over Britain. India too has adopted the branch banking system.

Under the unit banking system, however, the banking operations are carried through a single banking office rather than through a network of branches. Ordinarily, there is only one place of operation and no branches elsewhere but there may be branches within a strictly limited area. Under the unit banking system, the area of its operation as well as the size of the bank is smaller and far more limited than is the case under the branch banking system. Unit banking was popular in the U.S.A. at one time.

Advantages of branch banking:

i. **Proper distribution of capital:** The most important merit of a branch banking system is that it transfers capital from regions which have a surplus to those regions which require capital. There are two merits in such a transfer of capital between areas: (a) Capital is put to the most productive use and thus it promotes increased output and national income of the country, and (b) interest rates tend to be uniform throughout the country.

ii. **Diversification of deposits and assets:** Since the branch banking system covers a wide geographical area, there are greater possibilities of diversification affecting both deposits and assets. Deposits are received from

all areas, particularly from areas where savings are in plenty. At the same time, loans and advances are made in those areas where there is scarcity of money and where interest rates are high. Diversification here implies that a bank need not specialize in any particular area or particular industry, which will be true in the case of unit banking. If a particular industry or a region is in special difficulties, it will not affect the branch banking system, since the assets of the entire bank are behind every branch. Risks are scattered over a number of industries and over a wide area. The branch banking system is a great convenience to trade science trader - customers can get in contact easily with traders in other parts of the country and, in most cases, in other parts of the world too.

iii. **Loans and advances made on merit:** Under branch banking, loans and advances are made purely on merit and not on other considerations. The branch manager is not influenced by personal or local considerations in the granting of loans. Moreover, in the case of refusal to a particularly influential but not so creditworthy customer, the branch manager can always throw the responsibility of refusal on to the head office.

iv. **Large financial resources:** The great merit of the branch banking system lies in the advantages derived from large financial resources. The requirements of large customers can be easily met by the branch banking system. Loans and advances on a more liberal scale can be made. Further the failure of borrowers in any area, however big they made be, need not lead to the failure of the bank. In fact, one of the important merits of branch banking is its financial strength and ability to meet any crisis.

v. **Efficiency in management:** The branch banking system makes for greater efficiency in management. First of all, the best men may be recruited for top management. Branch managers can be carefully trained and supervised with greater opportunity for promotion for those who show good promise. Secondly, the advantages of top class business efficiency at headquarters are available to all branches.

vi. **Economy in working:** Besides efficiency in management, the branch banking system ensures greater economy in its working. Capital is made available in plenty and at cheaper rates; internal and foreign exchange business can be handled economically; and even small isolated towns and villages, where no independent bank can survive, can be provided with adequate and comprehensive banking facilities.

vii. **Central banking control effective:** Branch banking makes central banking control much more effective and easier than in possible when the central bank has to deal with innumerable unit banks. With a few big banks doing the major part of the business, as in England, and policies of the central

bank can be easily explained to the banking system and desired action brought forth. It is one of the factors which has helped the Bank of England to carry through its policies on several occasions.

Disadvantages of branch banking:

The critics of the branch banking system point out that (a) many of the above advantages are not realised in practice, and (b) some of the above advantages are available under the unit banking system also.

One demerit of the branch banking system is that there is much red tape and delay in granting special large loans and advances. This is because of the lack of sufficient authority to branch managers. In the case of any large loan, the branch managers have to refer to the head office and this often results in delay.

Secondly, the branch managers may not be familiar with local conditions and with the special problems and difficulties of local borrowers.

Thirdly, the funds of a particular locality may not be available for the development of that area but may be used elsewhere.

Fourthly, the branch banking system leads to concentration of enormous financial resources in the hands of a small number of men. Such a monopoly power is a constant source of damager to the community.

Other defects of branch banking system are: preferential treatment shown to firms situated near head offices, high interest rates charged in well - established localities to cover lower rates in developing regions, managerial and supervisory problems in managing and controlling far-flung branches, possibilities of mismanagement in branches, and so on.

Merits and demerits of unit banking:

Unit banking system has also some important merits of its own.

a. Resources of the locality are used the economic development of the locality and are not transferred to other areas.

b. The Unit banker has specialised knowledge of the local industries and occupations, customs and prejudices. He can serve the local needs of the small communities in an effective manner. In fact, he pays great attention to the financial problems and needs of the individual enterprises in his area.

c. Since the affairs of the bank are less clattered, there are very few possibilities for fraud and irregularities. Management and supervision do not offer any serious problems.

d. Lastly, unit banking is free from the diseconomies of large - scale operations which are generally associated with branch banking.

Among the disadvantages of unit banking, the most important is that a unit bank has limited financial resources and, therefore, cannot withstand a business depression or a run on it. Any difficulty in these industries will automatically land the bank also in difficulties. In fact, during the Great Depression of 1930s so many unit banks failed in the U.S.A - nearly 5, 10 banks - that it became clear that unit banks were ill-equipped to withstand adversity.

Another demerit of unit banking is that it is not able to provide full and adequate banking facilities to small communities because the area of its operations is restricted and the unit bank may not command adequate resources. Inadequacy of financial resources is responsible for the inability of unit banking system to support an efficient management.

Lastly, the unit banker, being a local man, may have to follow considerations other than strict economic principles in granting loans and advances. For instance, it may be very difficult and even dangerous for the banker to refuse an influential local businessman who may not be so creditworthy. If he lends, the businessman may default and land the bank in difficulties; and if the loan solvency of the bank and thus bring about the bank's failure.

To sum up, it is agreed all round that the branch banking system has far more substantial merits and has greater power of survival than the unit banking system. Even in America, traditionally considered as the home of unit banking, trend since 1930s has been towards branch banking, or to get the advantages of branch banking by what are known as group banking and chain banking systems.

Other Banking Systems:

There are three other types of banking systems also, vizs., the group, the chain, and the correspondent banks.

Group banking is one where two or more separately incorporated banks are brought under the control of a holding company which may or may not be a banking company. The banks so brought together may be unit banks or branch banks or both.

Chain banks refer to separately incorporated banks brought under common control by a device other than the holding company. This may be through some persons being directors of two or more banking companies or some groups of persons owing them.

Under the correspondent banking system, banks are linked together through deposits by smaller banks of some of their cash reserves with bigger banks. Here the bigger banks with which deposits are so made are called correspondent banks. These banks in turn may deposit some of their cash

balances with still bigger banks in metropolitan cities. The correspondent banks have export consultant whose services can be utilised by other banks depositing cash. The correspondent banks also transfer balances of banks.

1.3 DEPOSIT BANKING VS COMMERCIAL BANKING

England was the home of the pure commercial banking theory according to wh ch the main function of a bank in relation to industry was to meet the working capital requirements of business and industry. Banks lend essentially for short periods. The pure theory of banking assumes that a commercial bank cannot freeze its funds which are mostly short - term deposits in permanent capital investments in business undertakings. Mackenzie explain this point clearly: "The policy of our banks has always been to make advances to trade and industry for current and seasonal requirements and for short periods and not to lend capital for an indefinite term - departure from this policy and not to lend capital for an indefinite term - departure from this policy is attended with risk as the experience of some banks in the past unfortunately proved".

A very important reason for supporting deposit banking is the firm belief that banks are not only custodians but trustees also for the vast majority of depositors who have entrusted their hard - earned money with demand and this fact is never forgotten by good bankers. Naturally, they maintain a considerable percentage of their assets in the form of cash or highly liquid assets to meet withdrawals by depositors. Commercial banks, thus, concentrate on short-term loans and advances and leave to the specialised financial institutions - variously known as investment banks or development financial institutions (DFIs) - to provide fixed capital for industrial enterprises. Commercial banking is justified when the following conditions are present:

A very important reason for supporting deposit banking is the firm belief that banks are not only custodians but trustees also for the vast majority of depositors who have entrusted their hard - earned money with banks for safe custody. A great proportion of this money is payable on demand and this fact is never forgotten by good bankers. Naturally, they maintain a considerable percentage of their assets in the form of cash or highly liquid assets to meet withdrawals by depositors. Commercial banks, thus, concentrate on short - term loans and advances and leave to the specialised financial institutions - variously known as investment banks or development financial institutions (DFIs) to provide fixed capital for industrial enterprises. Commercial banking is justified when the following conditions are present:

a. There should be facilities and financial machinery to meet the fixed capital requirements of industry. In England and in India the issue houses and underwriting firms have helped in the floatation of new companies or of shares

and debentures of old and established companies. Our commercial banks were not, therefore, required to provide for the fixed capital requirements of industry. They could confine their activities to pure commercial banking.

b. The nature of banks should be such that they cannot lock up their funds for long periods. For instance, banks have a small percentage of capital and reserves as compared to their total deposit liabilities. The small percentage of capital and reserves implies that banks cannot acquire risky assets. At the same time, the presence of a large percentage of deposits, especially of the current account variety, implies that banks have to keep a high percentage of cash against deposits. Therefore, banks cannot acquire long-term assets, or speculative or risky or non - negotiable securities which cannot be easily converted into cash in an emergency. Banks have to be extremely cautious and their watchword should be safety and liquidity first and profit later. Failure to recognise this simple fact has resulted in their closing down.

c. If business and industrial ventures could be started through public subscription of the necessary capital and if they could finance their expansion and development by themselves (through ploughing back of profit) or through issue of shares and debentures in the market, the need for bank finance for investment in industries does not normally arise.

1.4. INDUSTRIAL BANKING VS DEVELOPMENT BANKING

Just as England was originally the home of commercial banking, Germany was initially the home of industrial or investment banking. In the second half of the 19th century, a number of banks were established in Germany whose primary aim was to promote industrial development through setting up new companies and consolidating the existing concerns. They generally carried on with their own funds (capital and reserves) and were essentially of the nature of investment trusts rather than industrial banks.

The most common method of promotion of companies in Germany was as follows: If a bank was satisfied with the plans of a company, it formed a Consortium or syndicate, that is, an association of various joint stock banks and also of private men, so as to facilitate the flotation of the new company. Every member of the Consortium pledged to accept a portion of the capital issue. The initiating bank generally became the director and constituted the central selling agency for all the securities. It kept common accounts and called upon members for contributions. The members of the Consortium being members of the stock exchange got the securities of the new concern listed in the stock exchange and thus added marketability to the investment. The Consortium was generally for a definite period after which it might be either terminated or renewed for a further period. Banks either kept the securities permanently or disposed them to later through the stock exchange. On the

termination of the Consortium, the total profit or loss as well as any remaining unsold securities were shared between the members in proportion to their participation.

Apart from helping the floatation of new concerns and investing funds in purchasing shares and debentures of industrial concerns, the German credit banks helped industrial units by the system of "Industrial Current Account", under which they lent to the industrial units to meet their working capital needs as well as long - term capital required for expansion, replacement and reorganization of plant and machinery. As P.B.Wahle puts it, "The industrial current account is the pivot of all transactions between bank and industry, promotion and issue transactions, direct participation in industrial undertakings and cooperation in management through a board of supervisors; these stand in very many cases in a close sequence with bank credit".

A very significant fact in the relationship between banks and industrial units in Germany was the exchange of representatives on the respective boards of directors or supervisors. Those banks which participated in the promotion of an industrial undertaking obtained representation on the supervisory boards of companies which were their customers. At the same time, they invited the leaders of commerce and industry to represent on the board of supervisors of banks. Thus, there was a very close relationship between industry and banks under the system of investment banking. In the words of P.B. Whale: "Without the vigorous and daring initiative of the banks, the present proud edifice of the German national economy could not have been erected in so erected in so relatively a short time".

1.5 BANKING IN THE INDIAN CONTEXT

Indian banks adopted the English system to banking from the very beginning, i.e., receive deposits from the public and lend and make advances to trade and industry for current and seasonal operations and for short periods. They did not consider lending capital for an indefinite term. At the same time, they were aware that they could not help in rapid industrialization of the country.

Indian public opinion had always advocated that Indian banks should play the same role as German investment banks did in the 19th century. The Central Banking Enquiry Committee (1931), in instance, recommended a limited participation by Indian Banks in industrial finance. Later, the Shroff Committee (1954) recommended increased but indirect participation by commercial banks in industrial finance through purchase of shares and debentures of the Industrial Finance Corporation of India (IFCI) and State Financial banks should give medium - term and long - term loans to industry and trade for development and expansion. According to the Committee, the Indian banks did not have the expertise and the resources to be involved in investment finance.

At the same time, there was the need for financial institutions to lend to industry and trade for development. The Government of India set up a series of specialised financial institutions with the cooperation of RBI. These institutions - IFCI, SFCs, ICICI, IDBI, SIDBI and others - were set up as public sector financial institutions to help industries with long - term capital funds. Their main work is to help development of industries.

It was, however, increasingly felt that the development financial institutions could not meet fully the needs of industry for medium-term and long-term finance. Accordingly, commercial banks in India have come forward to meet these needs. In this connection, some of the favourable factors which have appeared on the Indian banking scene should be appreciated:

a. Bank deposits have been increasing rapidly.

b. Rise in time deposits as compared to demand deposits has been spectacular, viz., rising from 27 per cent to 75 percent in recent years.

These two factors go to show that bank are acquiring larger resources, that an increasing proportion of these resources are for longer periods and that, therefore, it would be in the fitness of things if banks got interested in term loans to industry.

c. The Reserve Bank of India has been encouraging commercial bank to give up their traditional fear of term advances and go in for medium - term industrial finance. In fact, RBI has provided them with refinance faculties through the Industrial Development Bank of India.

Indian commercial banks have thus been displaying "commendable initiative in moving away from the traditionally commence - oriented character of their operation and in financing the expanding needs of industry to an increased extent". Banks have entered the field of financing industries through underwriting of shares and debentures and also through the granting of term loans. Some scheduled banks have embarked upon long term loan business against the mortgage of industrial property (such as plant and buildings).

While commercial banks in India are increasingly lending to industry for short and medium periods, the development financial institutions in India (DFIs) have argued in recent years:

i. The conventional distinction between commercial banking and development banking is getting blurred and that there is a need to move progressively towards universal banking.

ii. The DFIs should be allowed to convert themselves into banks over a period of time and should be permitted to provide both development finance and commercial banking services.

iii. In the short period, however, the DFIs may be permitted to set up wholly -owned or partly - owned banking subsidiaries to undertake commercial banking.

The first major event in this direction is the merger of ICICI (development and term lending financial institution) with ICICI Bank (deposit bank). This has resulted that the ICICI Bank will now extend loans for all terms short - term capital for current needs and working capital requirement and medium - term and long - term capital for development and expansion. ICICI Bank is the first major universal bank in the country. Other development financial institutions such as IDBI and HDFC are contemplating to merge with their counterpart banks and create universal banks.

Check your progress

Fill in the blanks

1. In the ____________________ every bank as a single legal entity having one board of directors and one group of shareholders, operates through a networks of branches through out the country.
2. Under the ____________________ banks are linked to gather though deposits by smaller banks with bigger banks.
3. Banks lend essentially for ____________________

Let us sum up

The development of commercial banks has taken place under different banking systems in different countries. From the organisation point of view various banks have been divided into Branch Banking and Unit Banking.

Branch Banking Business is carried out through more than me one office. Branch Banking enjoys the economics of large sale production remittance of funds from one place to another is possible at a lower cost. In unit banking, business is carried out through a single office or through a few branches operating within a limited area.

There are other systems of banking, namely, chain, group and correspondent banks. The banking system which combines commercial banking with investment banking is known as mixed banking now referred as universal banking. Industrial banking and deposit banking system also perform banking operation.

Glossary

Branch Banking : Branches operating through a ne branches.

Unit Banking : Banking operation are carried single office.

Corresponded Banking : Banks linked together through deposits by smaller banks with bigger banks.

Answers to check your progress

1. Branch Banking system
2. Corresponded banking system
3. Short period

Model Questions

1. Compare the merits and demerits of unit banking and branch banking. Which system would you recommend to India.
2. Explain commercial banking
3. Write short note on development banking.

Unit 2

COMMERCIAL BANK FUNCTIONS

STRUCTURE

Overview
Learning Objectives
2.1 Meaning of Commercial Banks
2.2 Functions of Commercial Banks
2.2.1 Acceptance of Deposits
2.2.2 Advancing of Loans
2.2.3 Investment of Funds
2.2.4 Promote the use of Cheques
2.2.5 Agency functions of the Commercial Bank
2.2.6 Purchase and Sale of Foreign Exchange
2.2.7 Financing Internal and Foreign Trade
2.2.8 Other function of the Commercial Bank
2.2.9 Creation of Credit
2.2.10 Fulfillment of Socioeconomic objectives
2.3 Creation of Credit
2.4 Utility of Commercial Bank
2.5 Role of Commercial Banks in Developed and Under Developed Countries
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

The development of commercial banking in ancient times was closely associated with the business of money changing. Throwing light on this, Adam Smith has observed. "the earliest banks of Italy, where the name began, were finance companies... to make loans to and float loans for the governments of cities in which they were found"... A commercial bank is essentially a dealer in money. It is a financial institution which accepts the demand and time deposits from businesses, institutions and individuals and engages in both business and consumer lending. The effort of a commercial bank is to maximise its total net earnings by employing its funds productively, which consists mainly of depositor's money.

LEARNING OBJECTIVES

This unit highlights the following:-

- Definition of Commercial banks
- Functions of Commercial bank
- Credit creation techniques and
- Role of commercial banks in developed and under developed countries.

2.1 MEANING OF COMMERCIAL BANKS

A commercial bank is a business organisation which deals in money, i.e., borrowing and lending of money. In this borrowing and lending of money it makes profit. The lending role of interest is higher than it pays to its depositors. It is because of this difference in lending and borrowing rates of interest that it is able to make profits.

Prof. Hart has defined the bank as follows:

"A banker is one who in the ordinary course of his business, receives money which he repays by honouring cheques of persons from whom or on whose account he receives it".

The Indian Companies Act, 1949, has thus defined the bank, "The 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.

We find that they lay emphasis on two important functions of the bank. Firstly, banks accept deposits from the public. Secondly, banks advance loans to the needy businessmen.

2.2 FUNCTION OF COMMERCIAL BANKS

The fundamental functions performed by the bank.

2.2.1 Acceptance of Deposits

The commercial banks accepts three types of deposits from the public.

i. **Fixed Deposit Account:** Money in this account is accepted for a fixed period, say, one, two or five years. The money so deposited cannot be withdrawn before the expiry of the fixed period. The rate of interest on this account is higher than that on other accounts. The longer the period, the higher is the rate of interest. In technical language, this type of deposit is known as time or term deposit. It matures at a definite date and entails an interest penalty if it is withdrawn earlier due to some emergency by the depositor.

ii. **Current Account:** The depositor can withdraw the money from his current account whenever he requires it. Generally speaking, the bank grants no interest on this account because it has to keep the cash ready at all times to meet the requirements of the depositor. This account is generally opened by businessmen who may have to withdraw money several times a day. The bank, however, levies certain incidental charges on the customer for the series rendered by it. It technical language, it is known as demand deposit or checking deposit. The debtor (i.e., bank) has to pay of the debt on demand either to the depositor himself or to anyone else whom he authorises by writing a cheque. The money represented by demand deposits is the debt of the bank. It is a liability for the bank but an asset for the depositor.

iii. **Savings Bank Account:** Some restrictions are imposed on the depositor under this account. For example, he can withdraw only a specified sum of money in a week. Of course, the depositors are given cheque facility to withdraw money from this account. The rate of interest allowed on this account is rather low. This type of deposit account encourages small savings in the country.

According to banking terminology, the bank deposits are divisible into two categories:

a. **Demand Deposits or Demand Liabilities:** These deposits refer to those deposits which are repayable by the banks on demand. These include current deposits and a major portion of the savings deposits.

b. **Time Deposits or Time Liabilities:** Time deposits are accepted by the banks for fixed time - periods and are not repayable before the expiry of the stipulated period. They include fixed deposits, recurring deposits and a part of the savings deposits.

Greater the volume of demand deposits, greater shall be the proportion of the liquid assets which the banks will be required to keep with themselves to meet their liabilities. In addition to the commercial banks, there are certain other institutions as well which specialize in the acceptance of both time and savings deposits. They are savings and thrift association, mutual savings banks, Credit Unions etc.

2.2.2 Advancing of Loans

The deposits received by the commercial banks are not allowed to lie idle in the cash box of the bank. After keeping certain cash reserves, the balance is given by the bank to the needy borrowers in the form of loans and advances. Before advancing loans to the borrowers, the bank satisfies itself fully about their creditworthiness. The various types of loans and advances are as follows:

i. **Making Ordinary Loans:** Here the bank gives a specified sum of money to a person or a firm against some collateral security. The loan money is credited to the account of the borrower and the borrower can withdraw to money from the account according to his requirements. The bank can recall such loans at its option.

ii. **Cash Credit:** Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time. What the bank does is that it opens the account in the name of the debtor and allows him to withdraw the money from time to time up a certain limit determined by the value of the stocks kept in the debtor's godown. The godown remains in the possession of the bank. The debtor continues to withdraw small sums of money according to his requirements, but he cannot exceed the credit limit allowed to him. The bank, however, charges interest only on the amount withdrawn from the account. This type of loan is very popular with the Indian businessmen.

iii. **Overdraft:** Sometimes the bank grants overdraft facilities to its respectable and reliable customers. The bank allows such customers to overdraw their accounts through cheques. The customers, however, pay interest to the bank on the amount overdrawn by them.

iv. **Discounting of Bills of Exchange:** This is another type of lending which is very popular with the modern banks. If the holder of an exchange bill needs money immediately he can get it discounted by the bank. After deducting its commission, the bank pays the present price of the bill to the holder. When the exchange bill matures, the bank can secure its payment from the party which had accepted the bill.

2.2.3 Investment of Funds

Besides loans and advances, a modern commercial bank also invests a part of its surplus funds in government securities and earns interest on them. In India, the commercial banks are required under statute to invest a part of their funds is government and other approved securities. Though the return from such securities is not very attractive, the funds invested in them are not only near liquid, but also secure from the risk of loss.

2.2.4 Promote the Use of Cheques

The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash. The cheque is the most developed type of credit instrument in the money market.

2.2.5 Agency Functions of the Commercial Bank

In addition to the above functions, the commercial banks performs certain agency functions for its customers. For these services, the bank charges certain commission from its clients. the various agency services rendered by the bank are as follows:

i. Transfer of Funds: The bank helps its customers in transferring funds from one place to another. The instrument used for this purpose is known as the 'Bank Draft'. For this service rendered, the bank charges a small commission from the customers.

ii. Collecting Customers' Funds: The bank collects the funds of its customers from other banks and credits them to their accounts.

iii. Purchase and Sale of Shares and Securities for its Customers. The bank buys and sells stocks and shares of private companies as well as government securities on behalf of its customers.

iv. Collecting Dividends on the Shares of the Customers. The bank collects dividends as well as interest on the shares and debentures of its customers and credits them to their accounts.

v. Payment of Premia: The bank pays premia to the insurance companies on behalf of its customers. It may also pay certain bills of the customers as per their directives.

vi. The Bank acts as the Trustee and the Executor. The bank preserves the 'Will's of the customers and executes them after their death.

vii. Income Tax Consultant: The bank may also give advice to its customers on income tax matters. It may even prepare the income tax returns of its customers on payment of its fee.

viii. Acts as Correspondent: The bank any also act as a correspondent, agent, or representative of its customers. The bank may obtain passports, travelers' tickets and even secure air and sea passages for its customers.

2.2.6 Purchase and Sale of Foreign Exchange

The commercial banks also carry on the business of buying and selling foreign currencies. Ordinarily, the sale and purchase of foreign currency is done by the Foreign Exchange Banks. But in India, some commercial banks in addition to their other functions, also do business in foreign exchange.

2.2.7 Financing Internal and Foreign Trade

The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short - term loans to traders on the security

of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.

2.2.8 Other Functions of the Commercial Bank

The are as follows:

i. **Safe Custody of Valuable Goods:** The modern bank provides locker facilities to its customers. The customers can keep their valuables, such as, gold and silver ornaments, important papers, shares and debentures in these lockers. The bank charges an annual rental for this service.

ii. **Issuing of Travellers' Cheques:** The bank also issues travellers' cheques or circular letters of credit for the benefit of its customers. The customers are saved from the botheration and the risk of carrying cash during their travels.

iii. **Giving Information about its Customers:** Since the bank is closely acquainted with its customers, it can pass on reliable information about their creditworthiness to other parties at other places. The businessmen often make use of this service to know about the credit worthiness of other parties at other places.

iv. **Collection on statistics:** The modern bank collects statistics about money, banking, trade and commerce, and publishes them in the form of pamphlets and handouts. This helps the bank's customers in acquiring knowledge about the latest economic situation on the basis of which they can formulate their business policy.

v. **Underwriting of Company Debentures:** Sometimes private companies issue debentures for public sale. But the public may hesitate in underwritten by the banks. the public has full confidence in the banks. If the debentures carry the signatures of a bank, the public would not hesitate in buying them. For underwriting these debentures, the bankers charge a small underwriting commission from the companies.

vi. **Accepting Bills of Exchange on behalf of Customers:** Sometimes, the banks accept exchange bills on behalf of their trusted customers. This benefits the customers because when the bank signifies its acceptance on the exchange bill, it becomes readily discountable in the money market.

vii. **Giving Advice on Financial Matters:** Since the bank is fully acquainted with the economic situation in the country, it is in a position to render useful advice to its customers of financial matters.

2.2.9 Creation of Credit

As point out above, granting of loans and advances is an important function of the commercial bank. But the process by which the bank grants loans and advances has special significance for the modern economy. As is well

known, when the bank grants a loan to its customers, it generally does not lend out cash, equal to the amount of the loan, to the customer as an individual moneylender does, but, on the contrary, opens an account in his (borrower's) name and credits the amount of the loan to his account. Thus, whenever a bank grants a loan, it creates a deposit or a liability against itself. Since the deposits of the bank circulate as money, the creation of such deposits leads to a net increase in the money stock of the economy. This is known as creation of money or creation of credit by the bank. A modern bank, during its operations, creates quite a good deal of money which has a far-reaching influence on the course of economic activity in the country.

2.2.10 Fulfillment of Socioeconomic Objectives

In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socioeconomic objectives laid down by the State. For example, the nationalised banks in India (representing 85 percent of the total banking business in the country) have framed special innovative schemes of credit to help small agriculturists, village and cottage industries, retailers, artisans, the self - employed persons through loans and advances at confessional rates of interest. Under the Differential Interest Scheme (D.I.S.) the nationalised banks in India advance loans to persons belonging to schedule tribes, tailors, rickshaw - walas, shoe - makers at the confessional rate of 4 percent per annum. This does not cover even the cost of the funds made available to these priority sectors. Banking is, thus, being used to sub serve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

From the above discussion, it is evident that a modern bank plays a very vital role in the economic activity of the country. It plays the role of a financial intermediary. It accepts deposits, makes loans and advances and buys negotiable securities. Without it, the individual saver-investor would have to deal directly with individual borrowers. The modern bank acting as an intermediary enables the individual saver to secure reasonable return without undergoing the botheration of confronting a borrower. It is the botheration of confronting a borrower. It is on account of this that a well - developed banking system provides a firm and durable foundation for the economic development of the country.

2.3 CREATION OF CREDIT

The modern banks create deposits in two ways. Firstly, in a passive way this results in primary or passive deposits. Secondly, in a more active way this results in active or derivative deposits.

Primary or Passive Deposits: The bank creates passive deposits when it opens a deposit account in the name of the customer who brings cash or cheques to be credited to his account. In this case, the role of the bank is merely passive. It has merely accepted the cash or the cheques brought by the customer and deposited are known as passive or primary deposits. It is these deposits which form later on the basis of loan transactions by the bank. In other words, it is out of these primary or passive deposits that the bank makes loans and advances to its customers. In fact these deposits merely convert currency money into deposit money.

Derivative or Active Deposits: These deposits are created by the bank in a more active manner by opening a deposit account in the name of the person who comes to the bank to borrow funds from it. Since the bank plays an active role in the creation of such deposits, they are known as active deposits.

THE TECHNIQUE OF CREDIT CREATION: DEPOSIT MULTIPLIER

Demand deposits or cash deposits are money and are used as such, for every depositor who has a current account in a commercial bank can meet his obligations through cheques drawn on his account. Expansion or contraction of demand deposits, therefore, means expansion and contraction of money in the country.

Banks have the power to expand or contract demand deposits and they exercise this power through granting more or less loans and advances and acquiring other assets. Now, this power of commercial banks to expand deposits through expanding their loans and advances is known as credit creation.

Bank credit refers to bank loans and advances and credit creation literally means the multiplication of loans and advances. As every bank loan creates an equivalent deposit, credit creation by banks implies also multiplication of bank deposits. The word "creation" implies that banks are unique institutions and that they can create bank deposits or create bank money.

Credit creation can be defined as the expansion of bank deposits through the process of more loans and advances and investments.

TECHNIQUE OF CREDIT CREATION

Let us explain, in a highly simplified manner, the technique or the process of credit creation by assuming:

a. the existence of a number of banks, A, B, C, D etc. each with different sets of depositors;

b. every bank has to keep 20 per cent of cash reserves according to law; and

c. a new deposit of Rs.1,000 has been made by a depositor with Bank At to start with.

After the new deposit of Rs.1,000 has been made in Bank A, the balance sheet of Bank A (taking only the new transaction) is as follows:

Balance Sheet of Bank A

Liabilities	Rs	Assets	Rs
New Deposit	1,000	New Cash	1,000
Total	1,000		1,000

Bank A has to keep only 20 per cent cash reserve, i.e, Rs.200 against its new deposit; it has a surplus of Rs.800 which it can employ profitably.

Balance Sheet of Bank A

Liabilities	Rs	Assets	Rs
Deposit	1,000	Cash	200
		Loan to Mr.X	800
Total	1,000		1,000

The creditors of Mr.X, who got Rs.800 from the latter, may be assumed to deposit the amount with their bank, viz., Bank B (This assumption is unnecessary, for creditors of Mr.X may be banking with Bank A and depositing Rs.800 with Bank A itself). The balance sheet of Bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Rs	Assets	Rs
New Deposit	800	New Cash	800
Total	800		800

After keeping a cash reserve of Rs.160 (viz., 20 per cent of Rs.800), Bank B is free to lend the balance of Rs. 640 to any one. Suppose that Bank B buys bills of exchange worth Rs.640 from the market - buying bills is known as discounting - and pays for them. The balance sheet of Bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Rs	Assets	Rs
Deposit	800	Cash	160
		Bills of exchange	640
Total	800		800

We can assume that the sellers of bills of Bank B who received Rs.640 from Bank B would be depositing the amount in their bank., Viz., Bank C. Bank C's balance sheet will be as follows :

Balance Sheet of Bank C

Liabilities	Rs	Assets	Rs
New Deposit	640	New Cash	640
Total	640		640

Bank C finds that it has excess cash reserves to the extent of Rs.512 (since under 20 per cent cash reserve, it will have to keep a cash reserve of Rs.128 only against a deposit of Rs.640). Suppose that Bank C buys long - term government bonds from Mr.Y worth Rs.512 and pays for them. The balance sheet of Bank C will be as follows:

Balance Sheet of Bank C

Liabilities	Rs	Assets	Rs
Deposit	640	Cash	128
		Government bonds	512
Total	640		640

Now, Mr.Y who sold the bonds to Bank C for Rs.512 may be expected to deposit the amount with his bank, viz., Bank D which, in turn, will keep 2- per cent as cash reserve and lend the rest.

This process of a deposit becoming a loan or an investment which, in turn, becoming a new deposit, goes on and on till the original deposit of Rs.1,000 is completely exhausted. In other words, the original deposit of Rs.1,000 becomes additional of Rs.800, 640, 512, 410, 328, etc. It we add up all these deposits, the total will amount to Rs.4,999.99 or Rs.5,000.

Let us now summarise what we have explained above:

a. Bank credit is expanded by banks lending more and buying more assets;

b. Bank credit eventually comes back to the banking system in the form of new deposits to become the basis for new bank credit; and so on.

Essentially, therefore, two processes are taking place in the banking system

Simultaneously:

a. Bank credit is created and as a result.

b. Bank deposits are multiplied.

These two processes are called credit creation on the one side and deposit multiplication on the other. Credit creation is the cause and deposit multiplication is the effect.

The Formula of Credit Creation: Deposit Multiplier

As deposit multiplication depends upon the ratio of cash reserves to deposits, the deposit multiplier is:

$$k = \frac{1}{r}$$ in which

k = Deposit multiplier

r = ratio of cash reserves to deposits

If cash reserve ratio is 20 per cent or 0.2, the deposit multiplier is

$$k = \frac{1}{r} = \frac{1}{0.2} = 5$$

If, on the other hand, cash reserve ratio is 10 per cent or 0.1, the deposit multiplier is 10; and so on. The higher the cash reserve ratio, the lower is the deposit multiplier. The additional deposit cation (ΔD) will be the additional cash ΔMxTk.

Suppose that commercial banks get fresh cash of Rs.10 crores as a result of Government spending. They would be able to multiply deposits through loans and investments to the extent of Rs.50 crores (assuming a cash reserve of 20 per cent) or deposit multiplier of 5. That is,

$$\Delta D = \Delta M \times k$$

$$= \text{Rs.10 crores} \times 5$$

$$= \text{Rs.50 crores}$$

The Technique of Credit Contraction

Just as there is multiple expansion of deposits, there is multiple contraction of bank deposits too when cash is removed from the banking system. Suppose there are a number of banks in the banking system, and each bank has to keep a cash reserve ratio of 20 per cent against deposits. Let us further assume for the sake of simplicity, that, to start with, every bank has total deposits of Rs.50,000 and loans and investments worth Rs.40,000. Suppose that a depositor withdraws Rs.1,000 from Bank A (to be used for payments). The balance sheet of Bank A will then be as follows:

Bank A

Liabilities	Rs	Assets	Rs
Deposits	49,000	Cash	9,000
		Loans and Investments	40,000

Against deposit liabilities of Rs.49,000, Bank A requires Rs.9,800 as cash reserve (this is 20 per cent of deposits). But Bank A has only Rs.9,000, leaving it with a deficiency of Rs.800. Bank A has to make up this deficiency by disposing Rs.800 worth of bonds to Mr.X who pays by cheque on his account will Bank B. After Bank A has collected the amount from Bank B, the balance sheets of Banks A and B will be as follows:

Bank A

Liabilities	Rs	Assets	Rs
Deposit	49,000	Cash	9,800
		Loans and Investments	39,200

Bank B

Liabilities	Rs	Assets	Rs
Deposit	49,200	Cash	9,200
		Loans and Investments	40,000

By disposing of some assets Bank A has been able to restore itself to a satisfactory position (i.e., 20 per cent cash reserve to total deposits). However, the balance sheet of Bank B shows a reduction of Rs.800 from its deposits and of the same amount from its cash. This amount has been paid to Bank A against the sale of assets of Rs.800. Bank B requires Rs.9,840 against total deposits of Rs.49,200; but it actually has Rs.9,200. To make up the shortage of Rs.640, Bank B sells some of its assets to Mr.Y who may be banking with Bank C, and who issues cheque against Bank C in payment. After Bank B has received the payment from Bank C, the balance sheets of the two banks will be:

Bank B

Liabilities	Rs	Assets	Rs
Deposit	49,200	Cash	9,840
		Loans and Investments	39,360

Bank C

Liabilities	Rs	Assets	Rs
Deposit	49,360	Cash	9,360
		Loans and Investments	40,000

Bank B has adjusted itself, but Bank C has deficiency of cash which it will make up by disposing of its investment or by contracting loans. And this process goes on till all the effects are fully exhausted. Thus the original withdrawal of cash of Rs.1,000 from Bank A is followed by reduction of deposit of Rs.1,000 from Bank A and further reduction of deposits by Rs.800 from Bank B, of Rs.640 from Bank C, and so on the total contraction will amount to Rs.5,000. The process of contraction of bank deposits is the same as that of expansion - only it is the reserve direction. In this case also, there would be simultaneous reduction of bank credit and bank deposits.

LIMITATIONS ON THE POWER OF BANKS TO CREATE CREDIT

The commercial banks, it should be remembered, do not have unlimited power of credit creation. Their power to create credit is limited by the following factors:

1. **Volume of Currency in Circulation:** The commercial banks can create credit only on the basis of cash received from the public in the form of primary deposits. If the primary deposits are large, then the derivative deposits created on their basis will also be large. But the volume of primary deposits is closely connected with the actual volume of currency in circulation. If the volume of currency in circulation increases, the volume of primary deposits will also correspondingly increase, enabling the commercial banks to create a large volume of derivative deposits. On the contrary, if the volume of primary deposits with the banks will also decrease, leading to a decrease in the volume of derivative deposits created by the banks. Hence, the amount of currency in circulation constitutes a real limitation on the ability of the banks to create credit.

2. **Cash Reserve Ratio:** As already pointed out, credit creation is the reciprocal of the cash reserve ratio. Thus, the higher the cash reserve ratio, the smaller will be the volume of excess reserves available and smaller will be the volume of credit creation by the banks.

3. **External Drain:** Another limitation on credit creation is the existence of the external drain, as pointed out by Prof. Whittlesey. The commercial banks expand their credit creation on the basis of the excess reserves with them. They create derivative deposits in this process. Some of the borrowers are likely to withdraw part of their deposits in cash. With the withdrawal of cash, the excess reserves of the banks are automatically reduced. This reduces

their power of credit creation. Thus, the term 'external drain' refers to the cash withdrawn from the banks by the borrowers. It naturally reduces the excess reserves of the banks and curtails their power to create additional credit.

4. **Banking Habits of the People:** The power of the banks to create credit is also limited by the banking habits of the people of the country concerned. If the people of the country conduct most of their business transactions in cash rather than through cheques, then multiple credit creation by the banks will be rather limited. There shall be frequent withdrawals of cash: the banks' cash reserves will be reduced. With reduced cash reserves, the banks' power to create credit will also be curtailed. Further, if the loan money is utilised by the borrower for importing goods and making their payments in cash, then, to that extent, the power of the banks to create credit will be automatically reduced.

5. **Banks' Reserves with the Central Bank:** As is well known, every affiliated bank keeps certain reserves with the Central Bank of the country. The Central Bank keeps on changing the percentage of these reserves from time to time. When the Central Bank increases the percentage of these reserves, then the power of the commercial banks to create credit is reduced in the same proportion. On the contrary, 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. The reserves serve as the first line of defense, in case there is a 'run' on the bank.

6. **Obligation to maintain Statutory Liquidity Ratio:** In several countries, including India, the commercial banks are required under law to maintain a second line of defense in the form of near - liquid assets, such as, government bonds and securities, treasury bills and other approved securities which can be got easily encased in case an emergency arises. The banks in India are required under law to keep 34 per cent of their assets in near - liquid forms described above. This naturally reduces the lending resources with the banks and curtails their power to create credit to that extent.

7. **Monetary Policy of the Central Bank:** The extent of credit creation by commercial banks is also determined by the monetary policy pursued by the Central Bank of the country. As already pointed out, the Central Bank has the power to influence the volume of money in circulation and through this is can influence the volume of credit created by the banks. In addition, the Central Bank has also certain powerful weapons like the bank rate and the open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial banks.

8. **Supply of Good Collateral Securities:** The supply of good collateral securities is another limitation on the power of banks to create credit in the economy. As is well known, every loan made by the bank is backed up by some valuable security, like stocks, shares, bills, bonds, etc. If these collateral securities are not available in sufficient number, the bank cannot expand their lending activities and, consequently, cannot expand credit or money in the economy.

9. **Conditions of Trade and Business:** The power of the banks to create credit is also determined by the conditions of trade and business in the economy. During the period of prosperity, there is great scope for profitable investment, and hence, 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. On the other hand, during the period of depression, the scope for profitable investment is limited. Hence, the businessmen and industrialists are less inclined to borrow from the banks. Under these circumstances, the banks' power to create credit will be automatically reduced.

10. **Cash Transactions:** The existence of cash transactions in the economy sets still another limitation on the power of the banks to create credit. Banking habits have not yet taken firm roots in underdeveloped countries where most of the transactions have to be affected in cash. This explains the high proportion of currency in total money supply in underdeveloped countries. To that extent, banks' power to create credit is correspondingly reduced. But, as the economy devalues, the ratio of currency to total money supply decreases and that of bank money increases. This increases correspondingly the banks' power of credit creation in the economy.

2.4 UTILITY OF COMMERCIAL BANKS

Commercial banking in modern times is indispensable for economic progress of a country. In fact, the functions of modern commercial bankers and their utility to the community are so enormous that we simply cannot afford even to imagine, let alone experience, the inconveniences we would experience if commercial banks are closed. A short strike of even one day by the employees of commercial banks disrupts the entire economic activities in the country. All economic activities some directly while others indirectly - come to a standstill. It serves the community in numerous ways. Firstly, by accepting deposits, the banks promote the habit of thrift and savings among the people. These savings of the people later result in capital formation, which is the basis of economic progress in the country. Secondly, the banks also encourage industrial innovations and business expansion through funds provided by them to the entrepreneurs. Thirdly, the banks exercise considerable influence on the level of economic activity through their ability to create money in the

economy. Fourthly, through their lending policy, the banks can influence the course and direction of economic activity within the economy. Fifthly, the various utility within the economy. Fifthly, the various utility functions performed by the banks are of great economic significance for the economy. Such functions as cheap remittance of funds, accepting and discounting bills of exchange, agency functions, such as, collection of dividends and interest on behalf of customers are very important for the working of the modern economy. In fact, the economic development of a country is not possible without a sound system of commercial banking.

2.5 ROLE OF COMMERCIAL BANKS IN DEVELOPED AND UNDER DEVELOPED COUNTRIES

Commercial banking, though important for developed countries, as we have seen above, is of special importance for the economic growth of developing for the economic growth of developing and underdeveloped countries. No underdeveloped country can progress with out first setting up a sound system of commercial banking in the economy. The importance of a sound system of commercial banking for a developing country may be depicted as follows:-

i. **Capital formation:** The rate of saving is generally low in an underdeveloped economy due to the existence of deep-rooted poverty the country cannot be realised due to lack of adequate banking be realised due to lack of mobilise dormant savings and to make them available to the entrepreneurs for productive purposes, the development of a sound system of commercial banking is essential for a developing economy.

ii. **Monetization:** An underdeveloped economy is characterized by the existence of a large non - monetized sector, particularly, in the backward and inaccessible areas of the country. The existence of this non - monetized sector is a hindrance in the economic development of the country. The banks, by opening branches in rural and backward areas, can promote the process of monetization in the economy.

iii. **Innovations:** Innovations are inessential prerequisite for economic progress. These innovations are mostly financed by bank credit in the developed countries. But the entrepreneurs in underdeveloped countries cannot bring of about these innovations for lack of bank credit in an adequate measure. The banks should, therefore, pay special attention to the financing of business innovations by providing adequate and cheap credit to the entrepreneurs.

iv. **Finance for Priority Sectors:** The commercial banks in underdeveloped countries generally hesitate in extending financial accommodation to such sectors as agriculture and small - scale industries, on account of the risks involved therein. They mostly extend credits to trade

and commerce where the risk involved is far less. But for the development of these countries it is essential that the banks take risks in extending credit facilities to the priority sectors, such as, agriculture and small - scale industries.

v. **Provision for Medium and Long-term Finance:** The commercial banks in underdeveloped countries invariably give loans and advances for a short period of time. They generally hesitate to extend medium and long term loans to businessmen. As is well known, the new businesses need medium and long - term loans for their proper establishment. The commercial banks should, therefore, change their policies in favour of granting medium and long - term accommodation to business and industry.

vi. **Cheap Money Policy:** The commercial banks in an underdeveloped economy should follow cheap money policy to stimulate economic activity or to meet the threat of business recession. In fact, cheap money policy is the only policy which can help promote the economic growth of an underdeveloped country. It is heartening to note that recently the commercial banks have reduced their lending interest rates considerably, i.e., from 20 to 24% to 14 to 16%.

vii. **Need for a Sound Banking System:** A sound system of commercial banking is an essential prerequisite for the economic development of a backward country. For the improvement of the banking system, in an underdeveloped country, the following points need special stress:

a. The system of branch banking is most suitable for a developing country. As such, it should be adopted by the government of the country in question. The number of branches should be multiplied so as to cover the rural, backward areas of the country.

b. The system of unit banking may also be developed to some extent to meet the local financial needs of the people. In other words, unit banks may be set up in bigger towns to meet the local requirements of trade and industry. This will have two advantages. Firstly, it will reduce the strain on bigger banks, and secondly, it will check concentration of financial power in the hands of a few big banks.

c. The banking system in underdeveloped countries should provide cheap remittance facilities to enable the movement of funds from one place to another so as to meet the requirements of trade and industry.

d. The loan policy of the commercial banks in underdeveloped countries needs to be rationalised. The loans should be given strictly for productive purposes, not for the purchase of luxury consumption goods. At the same time, the banks should not give credit to the businessmen for speculative purposes.

e. The commercial banks may also be persuaded to grant medium and long-term credit to agriculture and small-scale industries. At present, there are few financial institutions which cater to the medium and long - term requirements of agriculture and small - scale industries.

f. An efficient system of bank clearing is also essential to popularize the use of cheques in the public.

g. Steps should be taken to provide trained and efficient staff to the banks for the improvement of efficiency. The recruitment policy may also be rationalised and appointments be made strictly on merit.

With these changes, the commercial banking can play a useful role in promoting the economic development of developing and under developed countries.

Check your progress

Answer these short questions

1. Define commercial Banks ______________________________
2. What is primary deposits ____________________________________
3. Define Credit Creation ____
4. What are the two essential function of a commercial bank ______________________________

Let us sum up

Commercial banking has been known to the world from the earliest times. Banking company is accepts deposit as its principal business and advances money as loans. It is therefore a manufacture of credit and a machine for facilitating exchange. These banks functions on certain principles. The banker functions as a borrower and lender. It also performs many agency functions to its customers. It provides service oriented functions like issuing letters of credit, sale and purchase of foreign exchange and underwriting loans.

Though its function are accepting to deposits and granting loans, it also creates credit. The bank also creates active deposits when it purchases securities or other forms of assets from the public when the bank buys these abets, it makes payment to the sellers by opening a deposit account in their name. The bank may also create active deposits when it purchases bills of exchange in a similar way. Active deposits are created by the banks only when the people want to get loans from them and therefore, if there are no borrowers, there would be no active deposits. The process of credit creation is multiple in its nation. If we keep in is the entire banking system them an individual bank at best creates oredit which is only a fraction of the total original money received by the entire banking system. The banking system creates an amount of active deposits which is a multiple of the original depending upon the cash reserve

ratio to be maintained by the banks. The credit multiplier can operate forward as well as backward. When the bank receives primary deposits, it leads to multiple expansion of credit and when the bank loses a certain amount of cash, it leads to a multiple contraction of credit. In the former the multiplier moves forward and in the latter it moves backward.

Glossary

Commercial Banks : A commercial bank is a business organisation which deals in money i.e., borrowing and lending of money.

Primary Deposit : The bank creates primary deposit when it opens a deposit account in the name of the customer who brings cash or cheque to be credited to his account.

Active deposit : Opening a deposit account in the name of the person who comes to the bank to borrow from it is known as active deposit.

Answers to check your progress

1. Banking company is a company which carries on its principal business of accepting deposits subject to withdrawal by cheque or otherwise.
2. Merely accepting the cash or the cheques brought by the customer and are known as primary deposits.
3. Credit creation is defined as expansion of bank deposits through the process of more loans, advances and investments.
4. Accepting deposits and lending are the two primary functions of commercial banks.

Model Questions

1. "Loans create deposits". Comment what factors limit credit creation.
2. Explain the important functions of a modern commercial bank.
3. Explain the role of commercial banking in a developing and underdeveloped countries.

Unit 3

STATURE AND FUNCTION OF A CENTRAL BANK

STRUCTURE

Overview
Learning Objectives
3.1 Definition of Central Bank
3.2 Need for a Central Bank
3.3 Principles of Central Banking
3.4 Functions of a Central Bank
3.4.1 A Bank of Issue
3.4.2 A Friend, Philosopher and Guide to the Government
3.4.3 Custodian of Cash Reserves
3.4.4 Custodian of Foreign Exchange
3.4.5 Lender of last resort
3.4.6 A Bank of Central Clearance
3.4.7 Controller of Credit
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

The central bank occupies a pivotal position in the monetary and banking structure of the country. The central bank is the undisputed leader of the money market. The central bank also. The highest monetary institution in the country charged with the duty and responsibility of carrying out the monetary policy formulated by the government. According, to Samuel son. "A central bank is a bank of bankers. Its duty is to control the monetary base and through control of this `high powered money' to control the community's supply of money".

LEARNING OBJECTIVES

The central bank is in fact, indispensable for the banking system of the country; for controlling credit creations, for issuing paper currency for extending financial accommodation to member banks and for carrying out the monetary policy of the government. This unit describes these functions of the premier bank in detail.

3.1 DEFINITION OF CENTRAL BANK

According to Kent, it is "an institution which is charged with the responsibility of managing the expansion and contraction of the general public welfare. Vera Smith says that "the primary definition of Central Banking is a banking system in which a single bank has either a complete or residuary monopoly in the note-issue. It was out of monopoly in the note-issue that were derived the secondary functions and characteristics of our modern Central Banking." According to Shaw, a central bank is a bank which controls credit and Hawtrey on the other hand holds that a central bank is the lender of the last resort. To quote Shaw: "the one true, but at the same time, all-sufficing function of a Central Bank is control of credit". The statutes of the Bank for International Settlement define a central bank as: "the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country". De Kock regards central banking as a science. He defines a central bank as "a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions:

(i) The regulation of currency in accordance with the requirements of business and the general public, for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof. (ii) The performance of general banking and agency services for the state, (iii) The custody of the cash reserve of the commercial banks. (iv) The custody and management of nation's reserves of international currency, (v) The granting of accommodation in the form of re-discounts or collateral advances to commercial banks, bill brokers and dealers or other financial institutions, and the general acceptance of the responsibility of leader of last resort. (vi) The settlement of clearance balances between the banks, (vii) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state.

Similarly, Sayers has remarked that "the business of a central bank as distinguished from a commercial bank is to control the commercial banks in such a way as to promote the general monetary policy of the State. There are three fundamental points implicit in this:

(i) a Central Bank does not, as a commercial bank does, exist to make maximum profits, for its owners;
(ii) it must have some means of controlling the commercial banks; and
(iii) it is subordinate to the State.

3.2 NEED FOR A CENTRAL BANK

The need for a central bank arises from the vast expansion of monetary, fiscal and trade activities of the Government and the people and the concomitant

result of its activities produced on the economy. With the vast expansion of commerce and international trade, it has been necessary that commercial banks provide financial facilities for daily operations. The commercial banks perform this duty by creating credit. Indiscriminate expansion of credit or its contraction leads to fluctuations in the level of economic activity in the economy and all such fluctuations are bad for the health of the country's economy. Hence, some institution must be there to exercise control on the credit creation activities of the commercial banks and this institution has been the central bank. Again, after the disappearance of precious metals from the currency system and after the adoption of the paper currency, it has become extremely essential that the issuing of notes is undertaken by a single authority. The central bank issues paper currency only according to the needs and requirements of the country. And since it is also a controller of credit, it can easily feel the pulse of the economy and withdraw notes issued in excess of requirements or issue more notes, whenever required. Thirdly, a central bank is also needed to help the commercial banks in times of need or economic crisis. And that is why, the central bank has been called as a lender of the last resort. And finally, the central bank is a handmaiden of the Government and carves out its policy piously and sincerely. This has been possible only because the central bank exercises full control over the banking system of the country.

3.3 PRINCIPLES OF CENTRAL BANKING

Three main considerations govern the operations of a central bank; these are known as the fundamental principles of central banking. Firstly, the central bank is always motivated by the spirit of national Welfare. The operations of the central bank must always be guided by the objective of maximising the welfare of the people or the nation and not by maximising the profits as is the objective of commercial banks. It does not, however, mean that the central bank should undertake activities without keeping in view their financial implications or results. As a matter of fact when de Kock said that the central bank should work exclusively in the interest of public welfare he meant that profit earning should be a secondary consideration for a central bank and the maximisation of public welfare should be its primary objective. Secondary, the central bank's operations should aim at maintaining the monetary and financial stability in the economy. And from this point of view, every central bank has been provided with wide powers for controlling the monetary and banking structure of a country and for achieving this objective. Thirdly the central bank's activities should be free from all political considerations or influences. It should not be governed by the ideology of any particular political party. It does not mean that it should not work in using with the government of the country. What it means is that it is not the ideology of political party in

power that would decide its policy but the economic conditions of the country which should receive the foremost consideration from the central bank. Since the Government is also expected to solve the economic problems of the country and the central bank is also supposed to find out a solution for the economic problems of the country, therefore both these should work in cooperation with each other. Finally, a central bank should not compete with the commercial banks in the country or should not perform such banking transactions as accepting deposits from the general public and accommodate regular commercial customers with discounts or advances.

3.4 FUNCTIONS OF A CENTRAL BANK

3.4.1 A Bank of Issue

This was the first function which was originally undertaken by the central banks and that is why until the beginning of this century, they were known as banks of issue. The issue of currency has always been a prerogative of the state, but the state though it proper to hand over this function to banks. The commercial banks until the last century had the right of note-issue and the state introduced specific laws to regulate the note-issue granting partial or complete monopoly to one bank. The state might have been motivated in various countries for granting partial or complete monopoly to any one bank because it found that there was no uniformity in the notes issued by various banks; or because the notes issued by them were in limited quantity because the size of the reserves for banking these notes into cash. It has been recognised that this privilege was the primary factor in the development of central banking. By entrusting this responsibility to the Central Bank, the Government could ensure (i) uniformity in the monetary system, (ii) elasticity in the monetary system, (iii) of money, (iv) a constant source of profit and strengthening of the confidence of the people in the monetary system. It is on account of these advantages that the right to issue notes has been given to the central banks in almost all countries of the world.

3.4.2 A Friend, Philosopher and Guide to the Government

The central bank acts as a friend, philosopher and guide to the government. It is a banker, agent, advisor to the government. As a matter of fact, this was the first function performed by those institutions which were subsequently converted into central banks. It was later that the privilege of note issue was granted to them in lieu of loans made to the state. As a government's banker, the central bank credits the banking accounts of its govt., makes temporary advances to its govt. in anticipation of the collection of taxes or raises internal loans and extraordinary advances during emergencies like war, etc or carries out government's transactions involving the sale and purchase of foreign

exchange. It also acts as a financial agent as well as an advisor to the govt. The central bank keeps the accounts of the govt. in the same way as the commercial banks keep the accounts of their clients. The financial operations of the govt. are so huge that they entail enormous amount of accounting, clerical work and expense. The govt. in some cases, make specific payments to the central bank directly according to the turnover or an agreed yearly amount or indirectly through an arrangement whereby the govt. has to maintain a maximum credit balance in its accounts with the central bank, even if it has to borrow from the latter, at times in order to maintain its requisite balance.

3.4.3 Custodian of Cash Reserves

A Central bank is also a custodian of cash reserves of the commercial bank operating in the country. This function of a central bank has evolved through the passage of time and is closely associated with the other two functions discussed before. It is also because the central bank performs this function that it has been made the custodian of metallic reserves. The significance of the central cash reserve system can hardly be exaggerated; it is a source of great strength to the banking system of a country. It enhances the element of elasticity in the credit structure of the country. It needs two emergencies, namely –

(i) When few banks required additional funds, the reserves could be shifted to that bank where the need was greatest.

(ii) In case of general requirements of funds, the centralized reserve could be utilized for increasing the total amount of funds available in the market.

In the absence of centralization, commercial banks will have to keep more cash to need these emergencies. The central bank is also able to rediscount or create credit for meeting the cash requirements of the money market.

3.4.4 Custodian of Foreign Exchange

Metallic reserves are maintained against note issue as also against the entire credit structure, like deposits. The maintenance of adequate reserve is necessary to safeguard the monetary standard of the country. In gold standard, the central bank must maintain enough gold reserves. In inconvertible paper standard, the central bank should hold enough reserves of foreign exchange so that the external values might be maintained as desired. The central bank is required to maintain a minimum reserve against both its deposits and notes liabilities. This is required for covering the domestic note circulation in the domestic currency as well as in the international sphere.

3.4.5 Lender of last resort

This function of the central bank has emanated from its rediscounting functions. It implies that the central bank should be prepared to meet all reasonable demands for accommodation from commercial banks and other credit institutions, subject to certain conditions which form the main tenets of the discount rate policy of the central bank.

It does not, however, mean that for being the lender, the central bank must carry on re-discounting operations; otherwise it would not be that. A central bank may be a lender, without being a bank of re-discount, e.g., it may grant advances to the Government or to the public in times of monetary stringency.

It may, however, be noted be that this function is not free from abuses. It should be exercised with great caution. Firstly, the facility of rediscount could be abused by the commercial banks. They should not, therefore, have the privileges of seeking accommodation from the central bank at all times. A commercial bank does not become eligible to credit only because it has a legible paper, but also if its business is such as not to endanger the credit conditions. Secondly, the banks should not exercise economy in their reserves to such an extent as to necessitate accommodation even in normal times. In short, rediscounting facilities should not be treated as permanent capital, but should be availed of as and when necessary.

3.4.6 A Bank of Central Clearance

Central clearance implies the settling of differences between the various banks by making transfers of account at the central bank. The Bank of England adopted this function first and gradually it was adopted as an automatic function of a banker's bank. The central bank is a member of local clearing houses and performs daily the functions of settling differences between banks at the end of each clearing. This is a great convenience to the banking community.

3.4.7 Controller of Credit

The functions of the central bank discussed at the earlier paragraph, though evolved independently, are the natural options offshoots of the main function, namely, the control of credit performed by the central bank. There has been a severe fluctuation in the monetary field that necessitates credit control. The traditional objective of credit control was stabilization of rates of exchange, either through the maintenance of mono-metallic standards of bi-metallic standards. Bank deposits are become the most important source of money in the country in modern times. Commercial banks expand credit intensifying inflationary pressure and contract credit, thus contributing to deflationary situation. The central bank has an authority to control credit creation and

credit contraction by the commercial banks. As a controller of credit the central bank attempts to influence and control the volume of bank credit and to stabilize business conditions in the country.

Besides the above mentioned central banking functions, every central bank performs supervisory and promotional functions also.

Check your progress

State True or False:

1. The central Bank exists to make maximum profit (True/False).
2. The central bank's activities should be free from all political considerations or influences (True/False).
3. The central bank does not help the commercial banks in times of need (True/False).
4. The central bank is required to maintain adequate reserve to safeguard the monetary standard of the country (True/False).
5. Re-discount facilities should not be treated as permanent capital (True/False).

Let us sum up

A modern central bank performs so many functions of different nature that it is difficult to give any brief yet accurate definition of a central bank. Nevertheless, a central bank may be defined as that central monetary institution which is charged with performing the duties of banker's bank, fiscal agent for the government and managing the monetary system of the country.

The regulations of currency in accordance with the requirements of business and the general public and granting accommodation to commercial banks are the principal function of the central bank. The central bank also. Settler clearance balances between banks. Central banks in all countries acts as the fiscal agent, banker and advises on all important financial matters to the government of their countries.

Glossary

Central Bank : An apex bank which controls credit and regulates the volume of currency.

Central clearance : Central clearance, implies the settling of differences between the various banks by making transfers of account at the central bank.

Answers to check your progress

1. False 2. True 3. False 4. True 5. True

Model Questions

1. Explain the main functions of a central bank and show how it controls the quantity of currency and credit in the country.
2. Discuss the efficacy of the Bank rate and open market operations in controlling inflation.
3. Explain qualitative credit control.

Unit 4

METHODS OF CREDIT CONTROL

STRUCTURE

Overview

Learning Objectives

4.1 Objectives of credit control

4.2 Methods of credit control

4.3 Quantitative credit control methods

4.3.1 Bank rate or discount rate policy

4.3.2 Open market operations

4.3.3 Variable cash reserve ratio

4.4 Quantitative or selective credit control

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

Commercial banks significantly influence the total supply of money of by either creating or destroying credit. Since the commercial banks are primarily motivated by consideration of profit maximisation, the total credit supply required for economic stability in the country. First the commercial banks may not be aware of the quantity of credit control considered appropriate for economic stability and consequently of the right amount which they should create. Second, even if the hanks know about this amount, they may not care to abide by this limit in their credit creating activities because being essentially commercial firms their main interest lies in profit maximisation. Consequently, it is two much to expect the commercial banks to create the equilibrium amount of credit in the absence of exercising an effective control over their lending activities.

LEARNING OBJECTIVES

This unit explains the various method of credit control. The instruments of bank rate, open market operations and minimum legal cash reserves ratio are called the general instruments of credit control while moral suasion, credit rationing, selective credit control, cancellation of licenses of defaulting commercial banks etc. are direct instruments of credit control. This unit discusses the role of these credit control instruments in controlling the bank credit in the economy.

4.1 OBJECTIVES OF CREDIT CONTROL

The important objectives of credit control are given below:

Stability in the Internal Price level: As is well known, the economy of a country suffers a good deal as a result of violent fluctuations in the internal price level. Hence, the main objective of credit control is to establish stability in the internal price level. But this would be possible only if there is a proper adjustment between the supply of credit and the commercial requirements of the economy. What is implies is that the supply of credit should be adjusted strictly in accordance with the commercial requirements of the country. If the supply of credit is less than the commercial requirements, there is sure to be a decline in the price level. If, no the contrary, the supply of credit exceeds the commercial requirements, the internal prices are bound to rise up. Hence, the commercial banks should try to bring about a proper adjustment between the supply of credit and the commercial requirements of the country.

2. **Control of the Business Cycle:** As is well known, the operation of the business cycle causes an atmosphere of economic stability in a capitalist country. Hence, the objective of the credit control policies of the Central Bank should be to eliminate or at least to reduce the havoc caused by the business cycle. By varying the supply of credit, the Central Bank can, to some extent, control the operation of the business cycle.

3. **Stability in Exchange Rates:** Introducing stability in the foreign exchange rates can also be an objective of the credit control policy of the Central Bank. The instability in exchange rates can have harmful repercussions on the foreign trade of the country. Hence, the Central Banks, in those countries whose foreign trade is important, should pay special attention to the elimination of violent fluctuations in foreign exchange rates through credit control policy.

4. **Stabilization of the Money Market:** According to some economists, the credit control policy of the Central Bank should aim at the stabilization 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.

5. **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 Bank in these countries should try to solve the problem of financial stringency through planned expansion of bank credit.

6. **Meeting Business Needs:** According to Burgers one of the important objectives of credit control "is the adjustment of credit to the volume of business". Credit is needed at every step for meeting the requirements of trade, business and industry. As business expands, larger quantity of credit is needed.

7. **Checking outflow of Gold:** The Central Bank holds the huge gold reserves of the country in its vaults. Expansion of bank credit leads to general rise in prices which reduces exports and increases imports, there by creating unfavourable balance of payments. This leads to outflow of gold to other countries. The Central bank has to control credit in order to prevent such outflow of gold to other countries of the world.

8. **Preparation for War:** 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 requirements. Modern wars are to 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 out a large scale to meet the rising war expenditure.

4.2 METHODS OF CREDIT CONTROL

The principal methods (or, instruments) used by the Central Bank can be classified under two heads:

i) Quantitative or general methods, and

ii) Quantitative or selective methods.

The quantitative or the general methods are intended to expand or contract the total volume of credit in the banking system without devoting any though to the uses to which it is to be put. The qualitative or the selective methods are directed, on the contrary, towards the diversion of credit into particular uses or channels in the economy. These methods have nothing to do with the control of the total volume of credit in the economy. Their objective is mainly to control and regulate the flow of credit into particular industries or business.

The important quantitative or the general methods of credit control are as follows:

1) Bank Rate or Discount Rate Policy
2) Open Market Operations
3) Variable Cash Reserve Ratios

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1. Bank Rate or Discount Rate Policy
2. Open Market Operations
3. Variable Cash Reserve Ratios

4.3.1 Bank rate or discount rate policy

The bank rate policy is one of the principal methods of general credit control. It is the earliest method of credit control which was used by the Bank of England till the outbreak of the First World War. The bank rate can be interpreted in two senses. In the narrow sense, the bank rate may be defined as the minimum official rate at which the Central Bank as a Bank of Rediscount, rediscounts first-class bills of exchange brought to it by the discount houses and commercial banks. In the broad sense, the hank rate may be defined as the varying of the terms and conditions under which the market can have temporary access to the Central Bank either in the form of rediscounts or through secured advances.

The Central Bank, thus, tries to control credit (through Bank Rate Policy) by influencing both the cost as well as the availability of credit. The cost of credit is influenced by changing the bank rate. By raising the bank rate or the discount rate, the Central Bank raises the cost of credit, and by lowering the bank rate or the discount, rate, it lowers down the cost of credit. The bank rate policy also affects the availability of credit by changing the conditions under which the Central Bank grants loans to the commercial banks. By changing the eligibility rules, the Central Bank can influence the availability of credit. If, for example, the Central Bank prescribes strict eligibility rules, it can make it difficult for the commercial banks to secure loans from it. Thus, the bank rate policy influences both the cost as well as the availability of credit.

Conditions Essential for the Success of the Bank Rate Policy: The success of the bank rate policy depends upon the following conditions:

1) **Existence of Close Relationship between Bank Rate and other Interest Rates:** An essential condition for the successful working of the bank rate policy is the existence of a close and a definite relationship between the bank rate and the other market rates of interest. The existence of this relationship will result in the movement of market rates of interest in the same direction as the bank rate, thus, bring about the necessary changes in the volume of credit in the economy. When the bank rate is raised, all the other rates of interest in the market should also rise, and when the hank rate is lowered, the other rates of interest in the market should also fall. Now the existence of a close and definite relationship between the bank rate and the other interest rates is a feature of well-developed banking systems like those of the U.K., the U.S.A. and the other western countries. In underdeveloped countries, like India, there is no such close and definite relationship between the bank rate and the other rates of interest. This is the main reason why the bank rate policy has not proved effective in India and other underdeveloped countries.

2) **Existence of an Elastic Economic Structure:** The second condition for the successful working of the bank rate policy is the existence of elasticity in the economic structure of the country in question. This implies that the wages, costs and prices should be sufficiently flexible so that they can adjust themselves speedily to changes in the volume of credit brought about by the changes in the bank rate. If, for example, the bank rate is raised and the volume of credit shrinks leading to a fall in prices, then the wages and costs should be capable of automatic reduction so as to prevent producers from incurring heavy financial losses in their enterprises. Great Britain and other western countries had a flexible economic structure prior to the First World War. But after the First World War, and particularly since 1930, the economic structure in these countries lost its earlier resilience or elasticity. The wages and the costs now became rigid and failed to respond to changes in prices, consequent upon changes in the volume of credit. As a result, the bank rate policy failed to be as effective as it was before the First World War.

3) **Existence of Short-term Funds Market in the Country:** The third condition for the successful working of the bank rate policy is the existence of a well-developed and a well-organised short-term funds market in the country. This helps to handle foreign as well as domestic short-term funds that come up on account of changes in the interest rate consequent upon the changes in the bank rate. Such a type of short-term funds market helps to transmit changes in the bank rate to all the sectors of the economy. This will make the bank rate policy more effective in its results. But the difficulty is that such types of well-developed short-term funds markets do not exist in

underdeveloped countries like India. This is another reason for the ineffectiveness of the bank rate policy in these countries.

Limitation of Bank Rate Policy

Theoretically speaking, the bank rate policy is looked upon as an important weapon to achieve the following objectives:

i) Controlling the quantity of credit in the economy

ii) Restoring the equilibrium between saving and investment in the economy

iii) Correcting the disequilibrium in the balance of payments, and

iv) Maintaining the stability of exchange rates.

1) Non-existence of conditions for a Successful Bank Rate Policy: As pointed out above, the bank rate policy can succeed only if certain conditions are fulfilled. Unfortunately, the conditions described above are satisfied by the banking system of development countries only. In underdeveloped countries, these conditions are not satisfied with the result that the bank rate policy cannot be as successful in these countries as in western countries.

Further, the economies of these countries are far from elastic or resilient with the result have wages, costs and prices do not respond readily to changes in the volume of credit. What is more, in such economies the existence of undeveloped money and capital markets and the presence of the non-monetized sector further serve to blunt the edges of the bank rate policy.

2) Non-sensitivity of changes in Interest Rates: One of the assumptions of the bank rate policy is that changes in the market rate of interest have a decisive influence on entrepreneurial activities. But, in actual practice, this assumption does not turn out to be true. With the exception of speculative activities, where changes in the rates of interest may have some marginal effect, real entrepreneurial activities are not as much sensitive to change sin the rates of interest as assumed by the bank rate policy.

3) Non-effectiveness in Controlling Deflation: The difficulty with bank rate policy is that it is more effective in controlling inflation than in offsetting deflation. During a period of inflationary expansion of credit, an increase in the bank rate leads to higher market rates of interest with the result that bank credit becomes more expensive than before. This will discourage the businessmen from borrowing from the banks, with the result that the volume of credit will contract, thereby checking inflationary pressures in the economy. But when the bank rate is lowered during a period of deflation with a view to expanding the volume of credit, the expected result may not materialise because the lower rates of interest will not induce the entrepreneurs and the

businessmen to borrow and invest during a period of falling prices and falling profits. Thus, an important limitation of the bank rate policy is that it is less effective in controlling deflation than inflation.

4) **Existence of Conflict between the Internal and External Effects of the Bank Rate Policy:** Still another limitation is the emergence of a conflict between the internal and external effects of changes in the bank rate. For example, if the bank rate is pushed up in order to control domestic inflation, the resulting increase in the other interest rates may attract short-term foreign funds into the country, thereby endangering the success of the bank's anti-inflationary policy.

5) **Increasing Non-dependence of Commercial Bank on the Central Bank:** An essential condition for the success of the bank rate policy is the dependence of commercial banks on the Central Bank for rediscounting facilities and other types of financial accommodation. But, in recent years the commercial banks have come to acquire ample liquid resources of their own with the result that they have now no need to approach the Central Bank for financial accommodation in normal times.

6) **Non-effectiveness in Controlling Balance of Payments Disequilibrium:** The successful working of the bank rate policy in correcting the balance of payments disequilibrium presupposes the non-existence of artificial restrictions on foreign exchange and on the international flow of capital. This condition is satisfied nowhere these days. Governments in various countries have imposed all sorts of artificial restrictions on foreign exchange and on the international movement of capital. This has considerably reduced the influence of bank rate policy in recent years.

7) **Impersonal Nature of Bank Rate Policy:** A serious limitation of the bank rate policy is that it is highly indiscriminatory in character and affects productive as well as unproductive enterprises in a like manner. In other words, it makes no discrimination between productive and unproductive activities in the country. For example, if the bank rate is raised in order to curb speculative activities, the resulting rise in the market rates of interest will discourage genuine productive activities as well. In fact, this is the greatest weakness of bank rate policy as a method of credit control.

4.3.2 Open Market Operations

Open market operations as a method of credit control developed only after the First World War. The term 'Open Market Operations' is used in two senses. In the narrow sense, open market operations imply the purchase and sale by the Central Bank of government securities in the money market. But in the broad sense, this term implies the purchase and sale by the Central Bank not

only of government securities but also of other eligible papers, like bills and securities of private concerns.

Reasons for the Popularity of Open Market Operations: The increasing popularity of open market operations is due to the following reasons:

1) The effectiveness of open market operations as a method of credit control was proved beyond doubt during and after the First World War.
2) The open market operations as a method of credit control produce a more direct and immediate effect on credit conditions than the bank rate policy.
3) The scope for large-scale open market operations has increased in recent years due to the increased availability of government and other securities in the money market.
4) The ineffectiveness of bank rate policy emphasized the need for an alternative method of credit control. The Central Banks devised the technique of open market.

Objectives of Open Market Operations: Following are the objectives of the policy of open market operations:

1) To eliminate the Effect of Exports and Important of Gold under the Gold Standard: As is well known, when a country on gold standard imports gold, there is corresponding expansion in the,creation of credit in the banking system. The internal price level rises in consequence. If the Central Bank feels that the rise in the internal price level is not in the interest of the economy, then it can affect a reduction in the volume of credit through sale of securities. This will automatically result in a decline in the internal price level. If, no the other hand, the country on the gold standard is exporting gold to other countries, there shall be a corresponding reduction in the volume of credit money in the economy. This will result in a decline in the price level.

2) To impose a Check on the Export of Capital: If the country is exporting capital on a large scale to foreign countries and the Central Bank feels that this export of capital is not in the larger interests of the country, it can withdraw the surplus, money from the money market through sale of securities.

3) To remove the Shortage of Money in the Money Market: If, at any time, the money market experiences a shortage of funds which has adverse repercussions on business and industry, then, in such a situation, the Central Bank can increase the money supply by purchasing securities from the banks and the priva'e individuals.

4) To make Bank Rate Policy Successful: The open market operations are sometimes undertaken by the Central Bank to make its bank rate policy more successful as an instrument of credit control. For example, if the

commercial banks do not increase the interest rates consequent upon the increased bank rate, the Central bank can reduce their cash reserves by selling securities in the market. With their reduced cash reserves, the commercial banks will ultimately be compelled to increase their interest rates consequent upon the increase in the bank rate by the Central Bank.

5) **To check the 'Run on the Bank':** Sometimes, the commercial banks are confronted with a scramble by the depositors to withdraw their deposits due to some unfounded tumour in the market. Such a situation is technically known as 'Run on the Bank'. It can be a dangerous situation for the banks. Sometimes, the banks even fail in the face of the sudden rush of the depositors for withdrawing their deposits. To rescue the banks from such a dangerous situation, the Central Bank starts purchasing securities from the market. This results in the transfer of funds into the money market. With this, the confidence of the public may be restored and the 'Run on the Bank's checked.

Conditions for the Success or Limitations of the Policy of Open Market Operations: The success of open market operations depends on the fulfillment of certain conditions which may be set forth as follows.

1) **Existence of a Well-developed Securities Market:** An essential condition for the success of open market operations is the existence in the country of a well-organised and well-developed market for different types of securities which the Central Bank uses for its open market operations. In underdeveloped countries, thick condition is not properly fulfilled. There is no such securities market as is essential for the successful operation of the policy of open market operations in these countries. Hence, the policy of open market operations has not been as successful in the underdeveloped countries as in the developed countries of the west.

2) **Maintenance of a Definite Cash Reserve Ratio by the Commercial Banks:** The policy of open market operations implies that through the open market sale or purchase of securities the Central Bank is able to bring about a decrease or increase in the cash reserves of the commercial banks so that they will bring about corresponding changes in the volume of credit created by them. This necessitates the maintenance of a definite cash reserve ratio by the commercial banks. But if the commercial banks keep the cash reserves in excess of the fixed ratio or maintain other types of secret reserves, then the policy of open market operations will lose its effectiveness.

3) **Non-operation of Extraneous Factors:** The policy of open market operations may not prove successful on account of the operation of certain extraneous factors in the economy. For example, the open market purchase or sale of securities by the Central Bank may not always lead to corresponding increase or decrease in the cash reserves of the commercial banks due to

the operation of certain extraneous factors. It is possible that when the Central Bank purchases securities and injects additional cash into circulation, money may go out of the country due to an unfavourable balance of payments or the public may hoard a part of the additional cash put into circulation, or it is possible that the velocity.

4) **Non-conformist Attitude of the Borrowers:** The policy of controlling credit through open market operations may not succeed if the borrowers adopt a non-conformist attitude vis-a-via the commercial banks. Supposing, the Central Bank as well as the commercial banks are willing to expand credit in the economy, but still this objective of credit expansion may not be realized on account of the unwillingness of the borrowers to borrow funds from the commercial banks.

5) **Existence of an Adequate Stock of Securities with the Central Bank:** The policy of open market operations will prove successful only if the purchase and sale of securities is carried on an extensive scale. For this purpose, it is essential that the Central Bank should have in its possession a large stock of different types of securities.

6) **Non-existence of Direct Access of Commercial Banks to the Central Bank:** Another essential condition for the successful operation of the policy of open market operations is that the commercial banks should have no direct access to the Central Bank for financial accommodation. If the commercial banks have a direct access to the Central Bank, then the reduction in their cash reserves through open market sale of securities by the latter will be neutralised by the former through borrowing from the latter.

7) **Policy of Open Market Operations is more Effective in Controlling Credit than the Stimulating Expansion of Credit:** Another limitation of the policy of open market operations is that it is more successful in controlling an expansion of credit rather than in stimulating expansion of credit during depression. When the Central Bank sells securities in the market and reduces thereby the cash reserves of the commercial banks, the latter are obliged to reduce the creation of credit. But when the Central Bank buys securities thereby increasing the cash reserves of the commercial banks, the latter may not expand the creation of credit unless the borrowers are willing to borrow from them. During a period of depression the business prospects are not bright so that the businessmen and the industrialists cannot be induced to borrow despite the low interest rates offered by the commercial banks.

Despite the above limitations, the method of open market operations is a useful method of credit control. It is more direct and immediate in its effect than the policy of bank rate.

4.3.3 Variable Cash Reserve Ratio

The traditional methods of credit control, such as, the bank rate policy and the open market operations have several limitations. It is on account of these limitations that these two methods are found to be rather ineffective when the economy is confronted with abnormal circumstances. This happens particularly when there are excessive reserves with the commercial banks on the basis of which they are creating rather too much of credit. This overexpansion of credit may not be in the larger interest of the economy. But the two traditional methods like the bank rate policy and the policy of open market operations may not be able to control an inflationary situation like this.

For a long time, this method of Variable Cash Reserve Ratio was looked upon as an indispensable method of promoting the overall liquidity and the solvency of the banking system. The centralization of the cash reserves of the commercial banks in the Central Bank was supposed to promote the liquidity and solvency of the banking system. It inspired greater public confidence in the ability of the commercial banks to meet their obligations to the depositors. The public knew that the commercial banks could resort to the Central Bank for financial accommodation in times of emergency. But, in recent years, this view of the cash reserve ratio has undergone a change. It is now looked upon as an additional method which the Central Bank can utilise for effective credit control.

Limitation of the Method of Variable Cash Ratio

The method of credit control is subject to a number of limitations which may be set forth below.

1. The method does not prove effective when the commercial banks happen to have large excessive cash reserves with them. Even if the Central Bank raises the cash reserve ratio, the commercial banks will still be left with ample reserves after satisfying the statutory minimum requirements. They can continue to create credit on the basis of their residual reserve despite the increase in the cash reserve ratio. In other words, the creation of credit by commercial banks will not be curtailed despite the increase in the cash reserve ratio.

2. This method also fails to be effective when the commercial banks happen to have large foreign funds in their possession. Even if the Central Bank raises the variable cash reserve ratio and reduces thereby the reserve ratio and reduces thereby the reserves of the commercial banks, they will continue to create credit on the basis of foreign funds in their possession. To this extent, changes in the reserve ratio may only have limited effect on credit creation by the commercial banks.

3. The actual impact of this method also depends upon the demand for credit by the borrowers. Let us suppose that the Central Bank is desirous of expanding credit in the economy and, with that end in view, lowers down the cash reserve ratio of the commercial banks. The commercial banks, in their turn, may also like to offer greater credit facilities to a their customers. But this objective of expansion of credit may not materialize if the customers are not willing to borrow on account of the depressed business condition in the economy.

4. This method of Variable Cash Reserve Ratio is suitable only when it is desired to effect big changes in the reserves of the commercial banks. But when it is intended to make only marginal adjustments in their reserves, then the method of open market operations may prove to be more suitable than the method of variable cash reserve ratio.

5. Another limitation of the method of Variable Cash Reserve Ratio is that it is highly discriminatory in character. This method, as we have seen, discriminates against smaller commercial bank which happens to have smaller cash reserves with them. On the contrary, it discriminates in favour of the larger commercial banks because they are not so much affected by changes in the cash reserve ratio as the smaller banks. Moreover, this method also discriminates in favour of non-banking financial companies which are not required to keep cash reserves with the Central Bank. From this point of view, this method cannot be considered as just or equitable for all the constituents of the money market.

6. This method creates a lot of uncertainty for the commercial banks and limits their freedom to lend their resources to their customers. The commercial banks are always under the constant fear of a sudden increase in the cash reserve ratio by the Central Bank. They have, therefore, to keep plenty of reserves with them to meet the requirements of the Central Bank. It was on this ground that Lord Keynes recommended only small changes in the cash reserve ratio spread over a sufficiently long period of time to enable the commercial banks to adjust themselves to the new ratio.

7. This method also imposes under financial burden on the commercial banks insofar as no interest is paid to them by the Central Bank on cash reserves kept with it.

8. Since changes in the cash reserves have a direct and immediate effect upon the ability of commercial banks to create credit, it is indeed a very powerful and potent weapon which has been placed in the hands of the Central Bank for the purpose of controlling the creation of credit by the banking system. The Central Bank has to be very cautious in using this instrument because a slight carelessness on its part can produce harmful repercussions on the

entire economy. Hence, a great responsibility rests upon the Central Bank which should exercise this instrument with great caution and care.

9. The method of Cash Reserve Ratio may also generate a depressing effect on the securities market. If the commercial banks are called upon by the Central Bank to maintain a high cash reserve ratio, they may do so by disposing of their securities in the market. This sale of securities by the banks on a large scale may depress their prices in the market, bringing in their wake, heavy financial losses to the banks.

4.4 QUANLITATIVE OR SELECTIVE CREDIT CONTROL

Selective credit control is a recent development in monetary management by the Central Bank. The objective of quantitative methods is to control and regulate the total volume of credit in the economy, without bothering about the uses or the channels into which it flows. The objective of qualitative methods, on the other hand, is to divert the flow of credit into particular uses or channels in the economy. In fact, the objective of selective credit control is to encourage the flow of credit into those uses of channels which help the growth of the economy.

The methods of qualitative credit control are discriminatory in character. In fact, they discriminate is favour of those uses or channels which are considered to be desirable or productive for the economy. They discriminate against those uses and channels which are harmful for the smooth functioning of the economy.

Objectives of Selective Credit Control

The following are the main objectives of selective credit control.

1) To divert credit from undesirable and economically less urgent uses to more desirable and economically more urgent uses.

2) To control a particular sector of the economy without affecting the economy as a whole. For example, if speculative activities are going on in the economy and the Central Bank considers them harmful, it may, by exercising selective credit control, check the flow of credit to those activities. It may raise the margin requirements for secured loans to the speculators. This will result in checking the flow of credit to the speculators without affecting in any way other economic activities in the country.

3) To discourage excessive consumer expenditure on durable consumer goods financed by bank installment credit. For example, at the time of inflation, the Central Bank may decide to discourage consumer expenditure on durable consumer goods to prevent the prices from rising still higher. This can be done by the Central Bank by resorting to the regulation of consumer credit advanced by commercial banks.

4) To correct an unfavourable balance of payments of the countrv in question. This can be done by the Central Bank by providing cheaper credit to export industries with a view to expanding the exports of the country. At the same time, the Central Bank can raise the discount rate on import bills with a view to discouraging the import of goods into the country.

5) To bring under the control of the Central Bank credit created by private non-banking financial institutions. The methods of quantitative credit control are generally applicable to commercial banks only. The private non-banking financial institutions are not covered by these methods. And yet they are creating quite a substantial portion of the total volume of credit in the economy. The Central Bank can extend its control on these non-banking financial institutions by resorting to the methods of qualitative or selective credit control.

Types of Selective Credit Controls

The following are the main types of selective credit controls exercised by the Central Bank:

1. **Fixation of Margin Requirements on Secured Loans:** The margin is the difference between the 'loan-value' and the 'market value' of securities offered by borrowers against secured loans. By prescribing the margin requirements on secured loans, the Central bank does not permit the commercial banks to lend to their customers the full value of the securities offered by them, but only a part of their 'market value'.

The method of fixation of margin requirements is mostly used by the Central Bank to counter inflationary pressure sin the economy. This the Central Bank does by raising margin requirements on various types of secured loans. The raising of margin requirements on secured loans results in several advantages:

i) High margin requirements discourage speculative activities undertaken with bank credit and thereby lead to a diversion of resources from unproductive speculative activities to the fields of productive investments. The existence of high margin requirements, thus, discourages the borrowing of loans for speculative purposes.

ii) High margin requirements control inflationary pressures in two ways. First, by curtailing speculative activities, they lead to a decline in the speculative demand for goods which ultimately contributes to a fall in the price level. Secondly, high margin requirements, by diverting credit to productive activities, lead to an increase in the supply of goods and services which contribute to a fall in the price level.

iii) By reducing speculative activities, high margin requirements reduce the fluctuations in the market prices of securities.

iv) High margin requirements help in diverting financial resources from speculative activities to sound investment projects.

The Reserve Bank of India has been increasingly using this method in recent years to control bank advances against essential commodities like food grains, oil seeds, sugar, etc. with a view to preventing speculative dealings in such commodities.

2. **Regulation of Consumer Credit:** Another method of selective credit control is that of regulating the volume of consumer credit for the purchase of durable consumer goods. As is well known, durable consumer goods, such as, radios, refrigerators, washing machines, television sets, motor vehicles, etc. are purchased in western countries by the consumers on installment credit system. According to this system, a certain percentage of the price of the durable consumer goods is paid by the consumers in downright cash. The remaining part of the price of the goods is financed by bank credit which is repayable by the consumer in installments spread over a specified period of time.

This method controls excessive consumer demand for durable goods in the following way:

i) **By extending or curtailing the applicability of the method of consumer credit:** During a period of inflation, the Central Bank can extend this control to a large number of durable consumer goods. This will result in cutting down the demand for such goods.

ii) **By changing the minimum down payment:** The term 'minimum down payment' indicates the minimum amount of cash that the consumer himself has to pay at the time of purchasing the commodity.

iii) **By changing the maturity period of consumer credit:** The bank by increasing the period of maturity of the loans can encourage more consumer credit since in that case the consumer can repay the loan in that case the consumer can repay the loan in small and easy installments spread over a longer period of time.

iv) **By changing the cost of consumer credit:** If the bank raises the rate of interest on consumer loans, the volume of consumer credit will automatically tend to fall.

3. **Control through Directive by the Central Bank:** Sometimes, selective credit controls may be enforced on the commercial banks through directives issued by the Central Bank from time to time. These directives may be in the form of written orders, appeals or warnings by the Central Bank addressed to the commercial banks. These directives are issued to the commercial banks in order to realise the following objectives:

i. To control the lending policies of commercial bank.

ii. To divert credit from less urgent uses to more urgent uses or from the less productive uses to the more productive uses.

iii. To prohibit lending for certain purposes altogether.

iv. To fix maximum limits of credit for certain purposes.

4. **Rationing of Credit:** This is another weapon in the armory of the Central Bank.

The term 'rationing of credit' implies two things. First, it means that the Central Bank fixes a limit upon its rediscounting facilities for any particular bank. *Second*, it means that the Central Bank fixes the quota of every affiliated bank for financial accommodation from the Central Bank.

The method of credit rationing has, however, been subjected to criticism. This method conflicts with an important function of the Central Bank, namely, that Central Bank is the lender of the last resort. If the Central Bank acts as the lender of the last resort, then it cannot deny financial accommodation to a member bank even if the demand of the bank concerned exceeds its rationed quota. Moreover, this method can prove effective only when the banks approach the central Bank for financial accommodation. Another drawback of this method is that is proves effective only when the demand for credit exceeds its supply.

5. **Moral Suasion:** The method of moral suasion is still another method frequently employed by the Central Bank to exercise control on the commercial banks. This method involves advice, request and persuasion with the commercial banks to cooperate with the Central Bank in implementing its credit policies. If the commercial banks do not abide by the advice or request of the Central Bank, no punitive action is taken against them. The Central Bank merely uses its moral influence with the commercial banks to prevail upon them to accept its policies.

The method of moral suasion has also its limitations. The main drawback on this method is that it lacks legal sanction. As such, it fails to be effective at a time when the forces of credit expansion in the economy happen to be very strong and powerful. Nevertheless, this method has its uses and can serve as useful supplement to other methods of credit control.

6. **Publicity:** Several Central Banks have adopted publicity as an instrument of credit control. They use this instrument not only for influencing the credit policies of commercial banks but also to educate and influence a public opinion in the country. In fact, publicity is an essential instrument to ensure the effectiveness of the monetary policy of the Central Bank. Under this method, the Central Bank gives wide publicity to what is good and what is bad in the credit system of the country.

The Reserve Bank of India also periodically publishes returns and statements about the affairs of the commercial banks.

7. **Direct Action:** The method of direct action is most extensively used by the Central Banks to implement their credit policies. This method can be used to enforce both quantitative as well as qualitative credit controls by the Central Banks. The method is not used in isolation; it is used as a supplement to other methods of credit control.

Direct action against the erring banks can take the following forms:

i. The Central Bank may refuse altogether to grant discounting facilities to such banks.

ii. The Central Bank may refuse to sanction further financial accommodation to a bank whose existing borrowings are found to be in excess of its capital and reserves.

iii. The Central Bank may start charging penal rate of interest on money borrowed by a bank beyond the prescribed limit.

Limitations of the Methods of Selective Credit Control

Following are the main limitations of the method of selective credit control:

1) The methods of selective credit control are generally applicable to commercial banks alone. They do not apply to non-banking financial institutions which create quite a sizeable portion of the total volume of credit in the economy. The policies of these financial institutions may run counter to those of the Central Bank. To that extent, the desired objectives of selective credit control may be defeated.

2) It is difficult to distinguish between productive and unproductive uses of credit. Selective credit controls generally aim at diverting bank credit from the less productive to the more productive uses. As already said, it is exceedingly difficult for the commercial banks to make the distinction between productive and unproductive uses. To that extent, the effectiveness of the methods of selective credit control is reduced.

3) Another limitation of the selective credit control methods arises out of the fact that the commercial banks are not in a position to control the ultimate use of credit in the economy. The loans given by the commercial banks ostensibly for productive purposes may be used by the borrowers for speculative purposes.

4) There are no restrictions on clean credit under the selective credit control policy with the result that measures like higher margin requirements may be violated by the borrowers through securing clean loans from the commercial banks.

5) It is quite possible that the commercial banks through manipulations of accounts may advance loans to their customers for prohibited uses under various guises. Thus, the credit policy of the Central Bank may be defeated by the commercial banks in connivance with the borrowers.

6) The methods of selective credit control may not prove very effective in controlling credit in the economy, the reason being that investments these days are mostly financed by capital issues and loans from non-banking financial institutions. To that extent, the effectiveness of selective credit control policy may be correspondingly reduced.

7) The methods of selective credit control do not prove as effective under unit banking as they do under branch banking. In the U.S.A., where unit banking prevails, selective credit control has not proved very successful.

8) The methods of selective credit control may lose their efficacy if the merchants, traders and businessmen choose to carry on their economic activities *without* resources to bank credit. They may resort to trade credits or accommodation bills to escape the rigours of monetary discipline. To that extent, the efficacy of selective credit control is nullified.

9) Lastly, the relationship between credit and prices is not as simple and direct as is often made out to be by the economists. Prices are affected by a whole host of monetary and non-monetary factors, of which credit is but one, though not an insignificant factor. As such, it is not possible to exercise can effective control over the price level merely by controlling and regulating the volume of bank credit in the economy.

Check your progress

State True of False:

1. Expansion of bank credit leads to general rise in prices which reduces exports and imports leading to outflow of gold (True/False).
2. Bank rate may be defined as the maximum official rate at which the Central Bank rediscounts first-class Bills (True/False).
3. Open market operations imply purchase and sale by the central Bank (True/False).
4. Margin is the difference between the 'loan value' and the 'market value' (True/False).
5. Publicity is an essential instrument to ensure the effectiveness of monetary policy of commercial banks (True/False).
6. The central bank may refuse to grant discount facilities (True/False).

Let us sum up

The monetary policy a makers particularly the board of governors of the central bank in the country acts through. Monetary policy instruments also called credit control instruments. This affects the level of employment, rate of inflation economic growth. The central bank is empowered to exercise control over the leading or credit creating capacity of commercial banks in the country such that credit becomes an effective instrument of achieving the objective of economic growth with stability.

The central bank uses two methods - Quantitative and qualitative to control the creation of credit. The quantitative methods are Bank or discount rate, open market operations and variable cash ratio. These three methods are impersonal and objective in nature. They intend to control the total volume of credit in the economy without bothering about the uses to which the credit is to be put. These methods merely control the total volume of credit without regulating its flow into various uses of enterprises in the economy. These methods attempt to control credit creation of influencing the cash reserves of various affiliated commercial banks.

The methods of selective credit control are more suitable for under developed than for developed countries. The methods of general credit control are not easy effective in under developed countries on account of the absence of well-developed money markets. It is essential to direct credit to more essential industries in underdeveloped countries for speedier economic development. The methods of selective credit control can prove helpful in the achievement of these objectives.

Glossary

Margin : It is the differences between the 'loan value' and the 'market value' of securities offered by borrowers against secured loans.

Moral suasion : This is a qualitative method involving advise, request and persuasion with the central bank in implementory its credit policies.

Bank Rate : It is defined as the minimum official rate at which the central bank as a bank of rediscount.

Answers to check your progress

1. True	2. False	3. True
4. True	5. False	6. True

Model Question

1. Discuss the modus operate of the Bank rate. What are its limitation as an instrument of credit control.
2. What steps can be taken by the central bank to control of supply of credit.
3. What do you mean by selective credit control.
4. How is selective credit control supervisor to traditional monetary weapons.

BLOCK II

STRUCTURE OF BANKING SYSTEM

Unit - 5 : Structure and Characteristics of Banking System in India

Unit - 6 : Reserve Bank of India

Unit - 7 : Banking Regulation Act of 1949

Unit 5

STRUCTURE AND CHARACTERISTICS OF BANKING SYSTEM IN INDIA

STRUCTURE

Overview

Learning Objectives

5.1 Composition of the Indian Financial System

5.2 Structure of the Indian Banking System

5.3 Commercial Banking in India

5.4 Diversification in Banking

5.5 Reforms of the Banking Sector

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

Banking had not developed much in India prior to the British rule. The Government of India enacted in 1860 a law under which the banks could be organised on the basis of limited liability. The law considerably helped in the establishment of Joint - Stock Banks in India. Though Indian banking did not make any appreciable progress up to 1906, yet after this period there was considerable expansion of banking activities in the country. The new trends in Indian Banking were: nationalization of the Reserve Bank and Commercial banks, enactment of the Banking Regulation Act 1949, establishment of State Bank of India and provision of training in Banking. After two rounds of nationalisation (1969 & 1980) the private sector banks comprising of Indian Commercial Banks and Foreign Commercial Banks were set up. Despite various handicaps under which they had to labour, the private sector banks had done much better than their public sector counter parts.

LEARNING OBJECTIVES

The banking sectors in the recent past have achieved massive branch expansion and expansion in the volume of deposits. This unit highlight the:

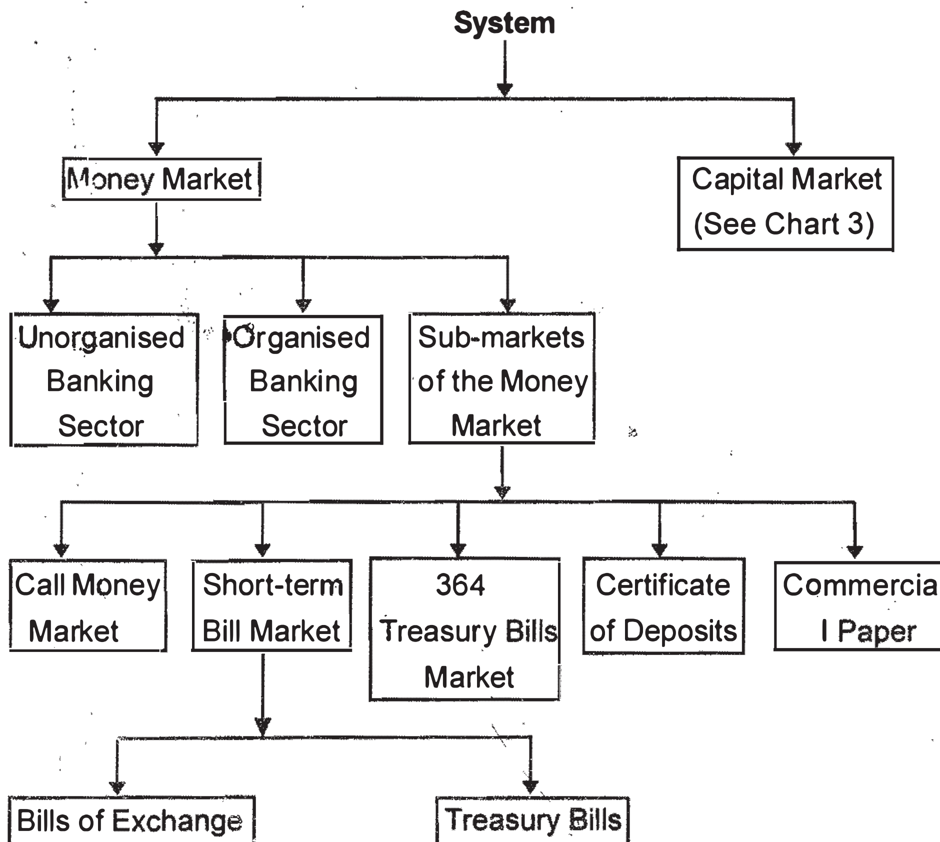
- Structure of the Banking System.
- Diversified Banking Function.
- Reforms suggested by Narasimham Committee.

5.1 COMPOSITION OF THE INDIAN FINANCIAL SYSTEM

The Indian financial system which refers to the demand for and supply of funds or to borrowing and lending of funds consists of two parts, viz., the Indian Money Market and the Indian Capital Market.

The Indian money market is the market in which short - term funds are borrowed and lent. The money market does not deal in cash or money but in bills of exchange - trade bills and treasury bills and other instruments, which are drawn for short periods. The capital market in India, on the other hand, is the market for medium - term and long - term funds. The organisation and structure of the Indian financial system can be explained with the help of a chart.

Chart 1 : Indian Financial

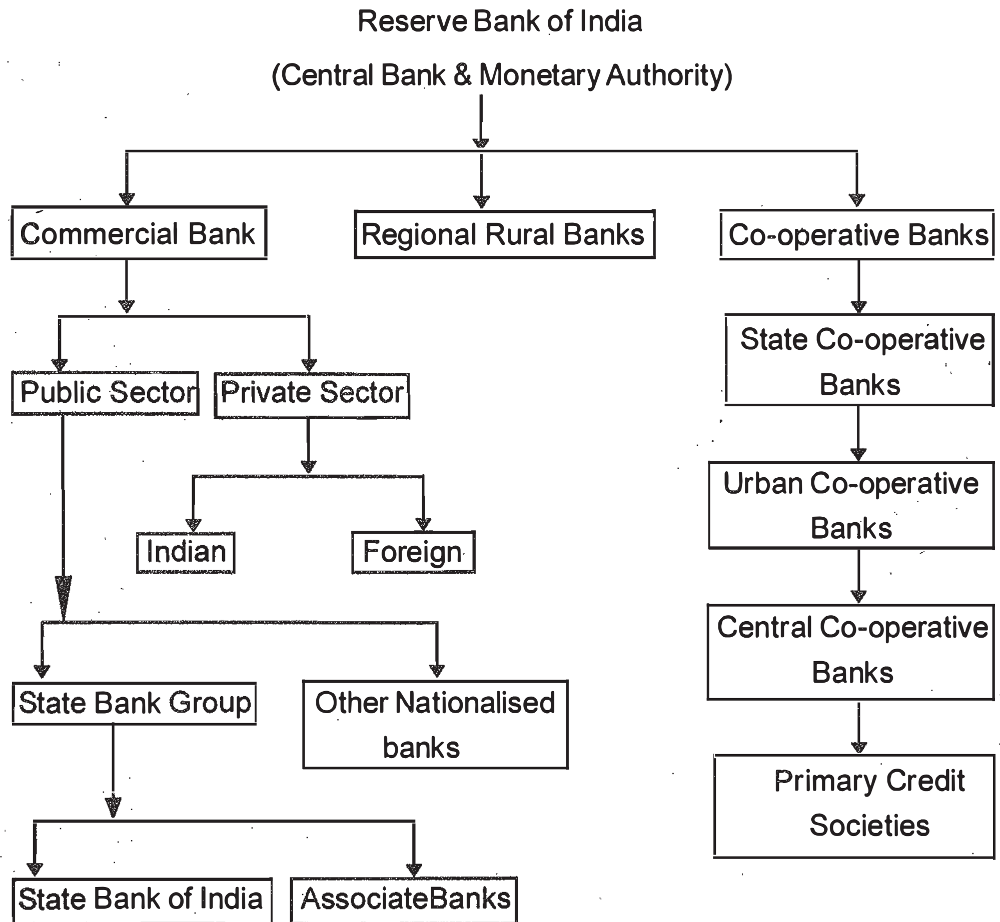


5.2 STRUCTURE OF THE INDIAN BANKING SYSTEM

The organisation of banking system in Indian can broadly be divided into three categories, viz., the central bank of the country known as the Reserve Bank of India, the Commercial banks and the Co-operative banks. As the supreme monetary and banking authority in the country, RBI has the responsibility to control the banking system in the country. It keeps the reserves of all commercial banks and hence is known as the "Reserve Bank".

Commercial banks have been in existence in India for many decades. They mobilise savings in urban areas and make them available to large and small industrial and trading units mainly for working capital requirements. After 1969, commercial banks are broadly classified into nationalised or public sector banks and private sector banks. The State Bank of India and its associate banks along with another 20 banks are the public sector banks.

Chart 2 : The Indian Banking System



The private sector banks include a small number of Indian scheduled banks which have not been nationalised and branches of foreign banks operating in India - commonly known as foreign exchange banks.

The Regional Rural Banks (RRBs) came into existence in the middle of 1970s with the specific objective of providing credit and deposit facilities particularly to the small and marginal farmers, agricultural labourers and artisans and small entrepreneurs. RRBs have the responsibility to develop agriculture, trade, commerce and industry in the rural areas. RRBs are essentially commercial banks but their area of operation is generally limited to a district.

Scheduled and Non - Scheduled Banks

Under the Reserve Bank of India Act, 1934, banks were classified as scheduled banks and non - scheduled banks. The scheduled banks are those which are entered in the Second Schedule of RBI Act, 1934. Such banks are those which have a paid - up capital and reserves of an aggregate value of not less than Rs.5 lakhs and which satisfy RBI that their affairs are carried out in the interests of their depositors. All commercial banks - Indian sand foreign, regional rural banks and State co-operative banks - are scheduled banks. Non - scheduled banks are those which have not been included in the Second Schedule of RBI Act, 1934. At present, there are only four or five non - scheduled banks in the country.

5.3 COMMERCIAL BANKING IN INDIA

In India, there are different kinds of banks each specialising in some field or the other. There are the money lenders and indigenous bankers who combine banking with trading and commission business. There are Indian Commercial banks - joint stock banks - which specialise in financing trade, commerce and industry. Some of these banks are associated with the Government and are known as Public Sector Banks (PSBs). There are other which are privately owned and managed, these are known as Private Sector Banks. There are foreign commercial banks which have branches in India specialized in financing external trade and commerce of India. Even now they are called foreign exchange banks. Above the entire banking structure is the Reserve Bank of India which controls and directs the Indian commercial banking system.

In this connection we should know the distinction between scheduled banks and non - scheduled banks, even though this distinction is irrelevant these days.

Under the Reserve Bank of India Act, 1934 banking companies incorporated in India should have minimum paid-up capital and reserves Rs.5 lakh if a bank has offices in more than one state and Rs.10 lakhs if it has branches in Mumbai or Kolkatta or both. These conditions were fixed in the 1930's, and those who fulfilled these conditions were known as the scheduled banks and those which did not fulfil were called non - scheduled banks. RBI, therefore, speaks of all:

a. Scheduled commercial banks - public sector banks, private sector bank and foreign banks are included;

b. Scheduled banks - in this category we include cooperative banks along with commercial banks; and

c. Public sector banks - in this category only banks which are associated with the Government are included. Here too we distinguish between.

i. State Bank of India and its seven associate banks known as the State Bank Group; and

ii. Nationalised banks - 19 in number.

The Indian banking system went through a series of crises and bank failures and consequently, its growth was quite slow during the first half of the 20th century. But after Independence, the Indian banking system recorded rapid progress. This was due to planned economic growth, increase in money supply, growth of banking habit, the setting up of the State Bank of India and its associate banks in the 1950's the control and guidance by the Reserve Bank of India and, above all, nationalisation of banks in July 1969.

5.4 DIVERSIFICATION IN BANKING

The changes which have been taking place in India since 1969 have necessitated banking companies to give up their conservative and traditional system of banking and take to new and progressive functions. The Government of India issued guidelines to the banks under Section 6 of the Banking Regulation Act permitting and encouraging them to diversify their functions.

Merchant Banking and Underwriting: Commercial banks have now set up merchant banking divisions and are underwriting new issues, especially preference shares and debentures, and they have been instrumental in the conclusion of deferred payment agreements between Indian industrial houses and foreign firms. Formerly, banks provided merchant banking services only to a few known companies. But now, they have floated separate subsidiaries and offer wider services to a large clienate. There are now eight commercial banks which have set up equipment leasing and merchant banking subsidiaries.

Mutual Funds: Some banks have now been permitted to float subsidiaries such as mutual funds (at one time, mutual fund operations were a monopoly of Unit Trust of India). In all, seven public sector banks have set up mutual funds and have floated as many as 30 schemes so far.

Developments in Retail Banking: Commercial banks in India are increasingly taking up retail banking as an attractive market segment with opportunities for growth and for profit. Retail banking refers to housing loans, consumption loans for purchase of durables, auto-loans, credit cards and educational loans. The loan values can average between Rs.20,000 to Rs.1 crore. The loans are generally for a duration of 5 to 7 years, with housing loans granted even upto a period of 15 years. Retail banking has been facilitated by growth in banking technology and automation of banking processes.

Automatic Teller Machines, (ATM, but some banks have called them as "Any Time Money") have emerged as an alternative banking channel which

facilitate low cost transactions. The use of ATMs by foreign banks and private sector banks has helped these banks to expand their reach and compete with public sector banks (PSB). PSBs are also rapidly introducing ATMs.

Internet Banking in India: Growth of the internet and wireless communication technologies, advances in telecommunications, etc. have dramatically changed the structure and nature of financial services. However, internet banking is only in a rudimentary stage in India. Even then, with the purpose of promoting safety and soundness for e-banking activities and as a precautionary measure, RBI has issued guidelines to the banks on internet banking covering (a) the risks associated with internet banking, (b) the technology and security standards for internet banking, (c) legal issues relating to this new type of activity and (d) the regulatory and supervisory concerns of RBI.

Venture Capital Funds: One public sector bank subsidiary and one foreign bank have launched Venture Capital Fund (VCF). The purpose of VCF is to provide equity capital for pilot plants attempting commercial application of indigenous technology and adaptation of previously imported technology to domestic conditions. The Government of India has issued detailed guidelines and procedures for the establishment of VCF, management structure, size and investment of the fund, etc.

Factoring Services: Some Public Sector Banks have set up separate subsidiaries exclusively for undertaking factoring services. Factoring is a new type of service which banks can provide. It is a device by which book debts are quickly realised through outright sale of account receivable to a financial intermediary (or a bank's subsidiary) called the 'factor'. The RBI has already accepted factoring in principle and banks are permitted to float subsidiaries to take up factoring.

Technology up gradation: In the last decade or so, the Indian Banking industry has made great strides in technology upgradation. For instance, electronic funds transfer (EFT) is available in 13 major cities of the country. RBI is now considering a proposal to commence national electronic funds transfer with a view to extending benefits of EFT to all locations in the country. If this proposal is implemented, it would be possible to make the facility of EFT available from any branch of a bank which has connectivity to the Indian financial network.

At present, transfer of funds on the "same day" basis is available at 4 metro cities with three settlements per day. Now, this has been extended to multiple settlements.

During the last three decades since bank nationalisation (1969), Indian commercial banks have transformed themselves beyond recognition. Their major business in the 1950's and 1960's was to finance trade and industry.

Banks have now taken up major responsibilities for developing and diversifying the Indian economy. They have come in a big way to help agriculture and hitherto neglected sectors. They have attempted to blend commercial banking with social banking. The need for a venues for profits have made them enter new fields of activity such as mutual funds, portfolio management, merchant banking, leasing and housing finance. Some of the banks have already floated subsidiaries for merchant banking, mutual funds and housing finance. In the future, banks may float many more subsidiaries to take up few lines of activity. They can be expected to diversify their functions and adopt new technologies.

5.5 REFORM OF THE BANKING SECTOR

The following measures, based largely on the recommendations of the Narasimham Committee (1991), have been taken as part of the banking reforms:

1. Statutory Liquidity Ratio (SLR) on incremental net Demand and Time liabilities (DTL) was reduced from 38.5 per cent to 25 per cent; however SLR on net total DTL was reduced by steps from 38.5 per cent to 33 per cent by march 1994, to 27 per cent in March 1997 and 25 per cent in October 1997 - this was the minimum stipulated under Section 24 of Banking Regulation Act, 1949.

2. CRR (Cash Reserve Ratio) on net total DTL was successively lowered from the statutory maximum of 15 per cent in 1992 to 11 percent in August 1998, till it touched 4.5 per cent in April 2003. The purpose of reducing CRR was to release funds locked up with RBI for lending to industrial business and other sectors which were starved of bank credit. RBI would aim at reducing CRR to the statutory minimum of 3 per cent of net DTL.

3. The important changes in the interest rates are:

   a. Interest rate on domestic term deposits above two years has been decontrolled.

   b. The Prime Lending Rate (PLR) of SBI and most other banks on general advances of over Rs.2 lakhs has come down.

   c. Interest rate on bank loans above Rs.2 lakhs fully decontrolled.

   d. The interest rates on deposits and advances of all co-operative banks (except urban co-operative banks) have been deregulated.

Scheduled commercial banks have now the freedom to set interest rates on their deposits subject to minimum rates and maximum ceiling rates. During 2002 - 2003, RBI has advised banks to (a) introduce flexible interest rate system for new deposits; (b) announce a maximum spread over PLR for all advances other than consumer credit and (c) reduce the maximum spread over PLR wherever they are unreasonably high.

4. Prudential norms for income recognition, classification of assets and providing of bad debts have been introduced for the first time. Banks have to complete provisioning for doubtful and sub-standard assets within a specified time frame. Because of the new norms, scheduled commercial banks had to make large provisions amounting to over Rs.10,000 crores for bad and doubtful advances in their portfolio. As the resulting losses would erode the already inadequate capital of the banks, the viability and financial health of the banking system was promoted by the Government of India through:

   a. Budgetary support of Rs.14,990 crores by the Union Government till 1994 - 1995 for the purpose of recapitalization of less strong public sector banks; these banks simultaneously agreed with RBI to strengthen bank management and improve efficiency; and

   b. Amendment of the Banking companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 authorising SBI and other nationalized banks to approach the capital market to raise fresh equity to meet shortfalls in their capital requirements. The Government would, however, continue to retain effective control on the public sector banks.

5. Capital Adequacy Norms were introduced which required:-

   a. 4 per cent to be attained by all banks by the end of March 1993;

   b. 8 per cent by the end of March 1996; and

   c. Foreign banks operating in India and Indian banks with branches abroad must attain 8 per cent by the end of March 1994.

In fact, all banks had attained the 8 per cent capital adequacy norm by the end of March 1996.

6. Access to capital market has been provided to SBI and other nationalized banks for debt and equity. SBI raised through public issue over Rs.3,200 crores as equity and bonds. The RBI shareholding of SBI is now 67 per cent as against 99 per cent earlier. SBI Act has been amended to allow 10 per cent voting rights to the shareholders. Oriental Bank of Commerce raised nearly Rs.390 crores from the market during 1994 - 1995. Since then, other banks too have raised funds from the market.

7. Freedom of operation has been given to scheduled commercial banks to open new branches and upgrade extension on attaining capital adequacy norms and prudential accounting standards. They are also permitted to close non-viable branches other then in rural and semi-urban areas.

8. Ten private sector banks have ready started functioning. New private sector banks are allowed to raise capital contribution from foreign institution investors upto 20 per cent and from Non - resident Indians upto 40 per cent.

9. In the 1996-97 Budget, the Government of India announced the setting up of new private Local Area Banks(LAB) with jurisdiction over three contiguous districts. These banks would help in mobilising rural savings and in channelling them into investment in local areas. The RBI issued guidelines for setting up such banks in 1996 and gave "in principle" approval for setting up of seven LABs in the private sector. Of these, licenses were issued to five LABs-Located-Andhra Pradesh, Karnataka, Rajasthan, Punjab and Gujarat. These LABs have commenced business.

10. Recovery of debts due to banks and financial institutions are facilitated with the passing of Recovery of Debts to Banks and Financial Institutions Act, 1993. Special Recovery Tribunals have been set up to facilitate quicker recoveries of loan arrears. An Appellate Tribunal has also been set up in Mumbai.

11. Securitization Act: The Government of India passed the Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The enactment of this Act marks a watershed in the process of on - going economic reforms. This Act provides for the setting up of asset management companies for addressing the problem of non - performing assets (NPAs) of banks and financial institutions.

The asset management company is authorised to acquire the assets of any bank or financial institution by issuing a debenture or bond or any other security for consideration agreed upon between such company and the bank or the financial institution.

In case of non - performing debts, a secured creditor is entitled to serve a notice to the borrower to discharge his liabilities within 60 days. Failing to discharge the liabilities in the stipulated time will entitle the secured creditor:

i. to take possession of secured assets;

ii. take over the management of the assets; and

iii. appoint any person to manage the secured assets.

Borrowers are entitled to prefer an appeal with the Debts Recovery Tribunal after depositing 75 per cent of the amount claimed by the secured creditor. Borrowers aggrieved by the order of the Debts Recovery Tribunal may prefer an appeal to the Appellate Tribunal within 30 days. The secured creditor is entitled to enforce any security interest created in its favour without the intervention of courts or Tribunals.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 puts in place a long overdue legal frame work without attendant delays for the recovery of NPAs in case of secured credit.

For realizing the benefits of this legislation, banks and financial institutions should see that assets taken over are kept in running condition till they fetch a good price.

12. Supervision of commercial banks is being tightened by RBI which has set up a Board of Financial Supervision with an Advisory Council to strengthen the supervisory system of banks and financial institutions. RBI has also established in December 1993 a new Department of Supervision for assisting the Board of Financial Supervision. There are extensive changes in bank inspection.

During 2002 -2003, RBI switched over to risk - based supervision of banks by introducing the scheme of prompt corrective action (PCA). In accordance with this scheme, notified in December 2002, RBI initiates certain structured and discretionary actions in respect of the banks which hit trigger points such as.

a. Capital to risk weights asset ratio (CRAR) which is less than 9% but equal to or more than 6% in this case, banks are required to submit and implement capital restoration plans. RBI may also order recapitalization.

b. NPAs of over 10% but less than 15% banks have to take special steps to reduce the stock of NPAs and contain generation of fresh NPAS. RBI may debar a bank from entering into new lines of business.

c. Where Return on Assets (ROA) is less than 0.25 per cent, banks will not access or renew costly deposits. RBI can debar such banks from incurring any capital expenditure other than for technological upgradation.

Apart from the above, RBI has announced that it can take any other action in the interest of bank concerned and its depositors.

Perspective

The highly regulated and directed banking system of India is being radically changed into one characterized by openness, competition, prudential and supervisory discipline. In the Report on Trend and Progress of Banking in India, 1992 - 1993, RBI states clearly, "Commercial banks thus need to become conscious that they are entering a challenging environment and will have to redefine their position within the financial industry. New ways and methods will have to be determined in order to successfully respond to the new challenges, particularly, the growing demands from customers for high quality service". This will necessitate commercial orientation of the commercial banks and they will have to:

a. provide better returns on the savings of the investors;

b. adopt strategies to generate additional revenues;

c. reduce the emerging financial risks through the creation of new services;

d. improve income to cost ratios and enhance operational effectiveness; and

e. address aggressively to the problems of depressed profitability and high and growing non - performing assets.

Narasimham Committee on Banking Sector Reforms (1998)

The Finance Ministry of the Government of India appointed Mr.M.Narasimham as Chairman of one more committee; this time it was called the Committee on the Banking Sector Reforms. The Committee was asked to "review the progress of banking sector reforms to-date and chart a programme on financial sector reforms necessary to strengthen India's financial system and make it internationally competitive". The Narasimham Committee on the Banking Sector Reforms submitted its report to the Government in April 1998. This Report covers the entire gamut of issues, ranging from capital adequacy, Bank mergers, the creation of global - sized banks, recasting bank boards and revamping bank legislation. Important findings and recommendations of this new Narasimham Committee (1998) are as follows:-

i. Need for a stronger banking system. The Narasimham Committee (1998) has made out a strong case for a stronger banking system in the country, especially in the context of capital account convertibility (CAC) which would involve large inflows and outflows of capital and consequent complications for exchange rate management and domestic liquidity. To handle such problems, India would need a strong and resilient banking and financial systems. For this purpose, the Narasimham Committee (1998) has recommended the merger of strong banks which will have a "multiplier effect" on industry. The Committee has, however, cautioned the merger of strong with weak banks, as this may have a negative impact on the asset quality of the stronger bank. The Committee has also suggested that two or three large Indian banks be given international or global character.

ii. Experiment with the concept of narrow banking. The Narasimham Committee on Banking Sector Reforms (1998) is seriously concerned with the rehabilitation of weak public sector banks which have accumulated a high percentage of Non Performing Assets (NPAs) and, in some cases, as high as 20 per cent of their total assets. The Narasimham Committee (1998) has, therefore, suggested the adoption of the concept of narrow banking to rehabilitate such weak banks. Narrow banking implies that the weak banks place their funds only in short term, free risk assets - these banks attempts to match their demand deposits by safe liquid assets. In case the concept of narrow

banking is found to be non - applicable to rehabilitate weak banks, the Government should examine the issue of their closure.

iii. The Narasimham Committee (1998) has argued: "While two or three banks with an international orientation and 8 to 10 large national banks should take care of the needs of the large and medium corporate sector and the larger of the small enterprises, there will still be a need for a large number of local banks". The Committee has suggested the setting up of small, local banks which should be confined to States or cluster of districts in order to serve local trade, small industry and agriculture. At the same time, these banks should have strong correspondent relationships with the larger national and international banks.

iv. The Narasimham Committee (1998) has also suggested that the Government should consider raising the prescribed capital adequacy ratio to improve the inherent strength of banks and to improve their risk absorption capacity. The Committee has suggested a higher capital adequacy requirements for banks and the setting up of an Asset Reconstruction Fund (ARF) to take over the bad debts of the banks.

v. Public ownership and real autonomy. The Narasimham Committee (1998) has argued that Government ownership and management of banks does not enhance autonomy and flexibility in the working of public sector banks. Accordingly, the Committee has recommended a review of the functions of bank boards with a view to make them responsible for enhancing shareholder value through formulation of corporate strategy.

The Narasimham Committee (1998) has considered the issue of "autonomous status" for the Board for Financial Supervision of RBI and the need to segregate regulatory and supervisory functions of RBI. The committee has expressed the need for RBI to distance itself from banks which are regulated and hints at the need for withdrawing RBI nominees from bank boards. The Committee states: "Regulation should be confined with laying down prudential and disclosure norms and sound procedures and ensure adherence to these and not get into the day-to-day management of banks".

vi. The Narasimham Committee (1998) has suggested the urgent need to review and amended the provisions of RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc. so as to bring them in line with the current needs of the banking industry.

Other recommendations relate to the need for computerisation process in public sector banks, professionalising and depolarising bank boards, review of recruitment procedures, training and remuneration policies, etc.

Really speaking, there was no purpose in setting up the second Narasimham Committee on Banking Sector Reforms even before a decade has elapsed for the full implementation of the recommendations of the First Committee (report submitted in 1991). As one critic has commented: "Barring, that is, a stray recommendation here or there like the categorical rejection of the merger cf weak with strong banks and the suggestion to try out narrow banking, as far as all other issues are concerned, whether it is organisation, restricting, freeing bank boards from day-to-day management and interference or segregating the regulatory and supervisory role of the Reserve Bank of India (RBI), it is like watching an action replay of the earlier report". We can attempt a comparison of some of the major recommendations of the 1991 and 1998 reports of the Committees presided over by Mr.Narasimham.

1998 Recommendations	**1991 Recommendations**
More strong banks	Merge banks to reduce numbers
Free bank boards from interference	Free bank boards from interference
Move to three-tier structure	Move to three-tier structure
Review capital adequacy norms	Fix capital adequacy at 8 per cent
Consider whether autonomy is	Ensure autonomy of banks: wind-up
Consistent with public ownership	Banking division of the Finance Ministry.

The setting up of the Narasimham Committee on Banking Sector Reforms (1998) was clearly unnecessary and was simply the brain wave of the official of the Banking Division of the Finance Ministry who have actually no work to do. It is worth noting here that two members of the Narasimham Committee (1991) clearly recommended the closing down of the Banking Division of the Finance Ministry as redundant and unnecessary and that all matters pertaining to the banking system should be the responsibility of only one authority viz., RBI. Obviously, this recommendation of the Minority of the Narasimham Committee (1991) was rejected by the Finance Ministry.

Check your progress

Fill in the blanks:

1. The Narasimham Committee suggested the setting up of ______________________ to take over the bad debts of the banks.
2. SLR means ______________________.
3. Automatic Teller Machines are also called __________ ______ by some banks.

4. Providing equity capital for pilot plants attempting commercial application is known as ________________.
5. When banks share are fully owned by the government they are called ________________.

Let us sum up

The Indian Financial System includes organised banking sector and unorganised banking sector. The unorganised sector consists of indegeneous bankers in the country who presume banking business on traditional lines. The Reserve Bank of India is the central bank, monetary authority and the leader in the Indian money market. The organised banking system in India can broadly be divided into three categories viz., the central bank of the country, commercial banks and the co-operative banks.

In the 20th century the Indian Banking system went through a series of crisis and bank failures. Rapid branch expansion influenced deposit growth in commercial banks particularly after nationalisation. The business condition in the country have been extremely favourable to the growth of bank deposits in the country.

The changes permitted the commercial banks to diversify their functions. Merchant Banking, Internet Banking are some of the diversified functions undertaken by commercial banks today.

The Narasimham Committee assumed the financial resources of the commercial banks came from the general public and that the bank funds were to be deployed for maximum benefit of the depositors. The Narasimham Committee reforms aimed at achieving operational flexibility, internal autonomy in the banks decision making process, and greater degree of professionalism.

Glossary

Unorganised Banking Sector : These consists of indigenous bankers who presume banking business on traditional lines.

Organised Sector : These consists of commercial banks in India both private and public.

Retail Banking : This refers to housing loans, consumption loans, credit cards and educational loans.

Answers to check your progress

1. Asset Reconstruction Fund
2. Statu[illegible] Liquidity Ratio
3. [illegible] Lime money

4. Venture capital
5. Public Sector banks

Model Questions

1. Explain the organisation of the Indian Banking System.
2. What is the diverse banking functions adopted today?
3. Explain the salient features of the Narasimham Committee Report.

Unit 6

RESERVE BANK OF INDIA ORGANISATION AND FUNCTIONS

STRUCTURE

Overview
Learning Objectives
6.1 Present Organization of the Reserve Bank of India
6.2 Main Functions of the Reserve Bank of India
6.3 Achievements of Reserve Bank of India
6.4 Failure of the Reserve Bank of India
Let us sum up
Glossary
Answer to check your progress
Model Questions

OVERVIEW

In 1921, the Government of India established the Imperial Bank of India to serve as the Central Bank of the country. In 1925, the Hilton Yong Commission suggested it was not desirable to keep the control of currency and credit in the hands of two separate agencies. The Government of India controlled currency while the Imperial Bank regulated credit prior to the establishment of the Reserve Bank of India in April 1935. The commission recommended the establishment of the Reserve Bank of India as the Central Bank of the country. The Reserve Bank of India Act was passed in 1934, and the Reserve Bank of India started functioning from 1st April 1935.

LEARNING OBJECTIVES

The Reserve Bank of India is the apex bank in our country. This unit discusses the organizations structure, functions, achievement and failures of the central bank. The Government of India renders the monetary control through the Reserve Bank of India. Hence it is essential to understand the functions of this premier bank.

6.1 PRESENT ORGANIZATION OF THE RESERVE BANK OF INDIA

The present organization of the Reserve Bank of India can be discussed under the following sub heads:

(i) Capital: The paid up capital of the Reserve Bank of India is Rs.5 cores. This has been divided into 5 lakh shares of 100 Rupees each. All the shares

of the Reserve Bank of India at the present moment are being held by the Government of India. The Reserve Bank is, therefore, a government institution. It was, however, a private shareholder's bank in 1935, when it was first established in the country. But the Government of India nationalized it on 1st January 1949. Under this law, the Government purchased the shares of all the private shareholders. The Government paid Rs.118.6 for every share of Rs.100 acquired by it. The Reserve Bank also had a Reserve Fund of Rs.150 crores in 1981-82.

(ii) Management: The management of the Reserve Bank is controlled by the Central Board of Directors. This Board consists of 20 members. This number is made up as follows:

One Governor and four Deputy Governors: They are appointed by the Government of India for a period of five years. Their salaries, allowances and other perquisites are determined by the Central Board of Directors in consultation with the Government of India.

Four Directors nominated from the Local Boards: There are four local Boards of Directors in addition to the Central Board of Directors. They are located at Bombay, Calcutta, Madras and New Delhi. The Government of India nominates one member each from these local Boards. The tenure of these directors is also for a period of five years.

Ten other Directors: The ten other directors of the Central Board of Directors are also nominated by the Government of India. Their tenure is four years.

One Government Official: The Government of India also appoints one Government official to attend the meetings of the Central Board of Directors. This official can continue for any number of years with the consent of the Government, but he does not enjoy the right to vote in the meetings of the Central Board. The Central Board of Directors must meet at least six times in years. There should be at least one meeting of the Board after every three months. The Governor of the Reserve Bank can call the meeting of the Central Board whenever he thinks it necessary. As pointed out above, there are four local boards to advise the central Board of Directors. Each local board comprises at least four members. These members are appointed by the Government of India appoints the members of the local boards in such a manner as to give representation to all the interest involved. The local boards not only render advice to the Central Board but also carry out the various tasks allotted to them by the Central Board. The Governor is the highest official of the Reserve Bank. There are four Deputy Governors to help and advise him. Each Deputy Governor is allotted a particular job to do, and he is fully held responsible for the proper execution of the job.

Offices of the Bank: The headquarters of the Reserve Bank is located at Bombay. But for the efficient performance of its functions, the Bank has opened local offices at New Delhi, Calcutta, Madras, Bangalore, Kanpur, Ahmedabad Hyderabad, Patna and Nagpur. The Bank can open its offices at any other place with the prior consent of the Central Government. The State Bank of India acts as the Agent of the Reserve Bank at those places where the latter does not maintain its own offices. The regional offices of the exchange control department of the Reserve Bank are located at New Delhi, Kanpur, Calcutta and Madras.

Departments of the Reserve Bank: There are at present 10 different departments of the Reserve Bank. They are as follows:

Issue Department: The main function of this department is to issue paper currency. Hence, this department arranges for the distribution of paper currency printed at the Nasik press amongst the treasuries and sub-treasuries of the Government. It also maintains regular accounts of the number of notes of different denominations printed at the Nasik Press. The department maintains its branches at Calcutta, Bombay, Madras, Nagpur, Bangalore, Hyderabad, Patna and New Delhi.

Banking Department: This department was setup on 1st July 1965. It performs two major functions. Firstly, it deals with government transactions and arranges the floating of loans on behalf of the Central and State Governments. It also arranges for the remittance of governmental funds from one place to another. Secondly, this department maintains the cash reserves of the scheduled banks and also extends financial help to them in times of emergency. This department functions as the clearing house for the scheduled banks.

Department of Banking Department: This was set up in the year 1950. The main objective of this department is to expand banking facilities in the rural areas and smaller towns. This department also encourages savings in the rural areas. To give training to the officials of the scheduled banks is also the responsibility of this department.

Department Banking Operations: The Reserve Bank of India has been given extensive powers to control and regulate the banking system under the Reserve Bank of India Act, 1934, and the Banking Companies Act, 1949. Hence, this department carries out periodical inspection of the scheduled banks and also analyses the balance sheets submitted by them. The department also grants licenses for opening new banks. It also considers the applications from the existing banks for the opening of branches at new places. No scheduled bank can increase its paid-up capital without the prior consent of this department. Nor can any amalgamation of the existing banks be possible

without the prior sanction of this department. This department also tenders useful advice to the scheduled banks in their day-to-day working.

Agricultural Credit Department: The main function of this department is to study the problems connected with agricultural credit. It also carries on research on rural credit problems with the help of experts. This department formulates the rural credit policy of the Reserve Bank of India. It grants facilities for rural credit to State Governments and State Cooperative Banks. It publishes from time to time its reports on agricultural credit.

Exchange Control Department: This department was established in September 1939, after the outbreak of the Second World War. In 1949, the Government of India passed the Foreign Exchange Control Act under which extensive powers were granted to this department to regulate and control the business of foreign exchange. The entire business of the sale and purchase of foreign exchange is being conducted by this department at present.

Industrial Finance Department: This department was established in September 1957. The main objective of this department is to extend financial assistance to small-scale and medium-scale industries in the country. This department also tenders advise to the various financial corporations in their day-to-day operations.

Non-Banking Companies Department: This department was set up in March 1966, with its headquarters at Calcutta. It looks after the activities of the non-banking companies and financial institutions in the country.

Legal Department: It was established in 1951. The main objective of this department is to tender advice to the various departments of the Bank on legal issues. This department also prepares the directives and the communiqués of the Reserve Bank of India. The Department also gives advise to the Bank on the proper implementation of all laws relating to banking in the country.

Department of Research and Statistics: The main function of this department is to conduct research on problems relating to money, credit, finance, production, etc. In addition, this department also collects statistics about the various sectors of the economy. It publishes them from time to time for the benefit of the Government as well as the public. This department renders valuable service to the Government in the formulation of its economic and financial policies. The Government of India can also seek the advice of this department in the solution of various economic problems.

6.2 MAIN FUNCTIONS OF THE RESERVE BANK

The Reserve Bank of India performs a large variety of functions in its capacity as the Central Bank of the country. Those functions can be subdivided under two heads:

Central Banking Functions of the Reserve Bank

Following are the main Central Banking functions of the Reserve Bank of India:

1. The Reserve Bank of India issues Paper Currency: The Bank enjoys complete monopoly of note issue. To perform this function, the Reserve Bank of India has established a separate department known as the Issue Department. This department maintains a separate account of its assets and liabilities. It publishes a separate statement of affairs every week. To maintain public confidence in paper currency, the Reserve Bank of India has made special arrangement to keep a reserve fund to back up the paper notes issued by it. Up to 1956, the Reserve Bank of India used to issue paper currency on the basis of the proportional reserve system. According to this system, the Reserve Bank of India had to keep 40 per cent of the total value of paper currency in gold, gold coins and foreign securities. The gold in the reserve fund was evaluated at Rupees twenty-one, thirteen annas and ten pies (Rs.21-13-10) per tola. The remaining 60 per cent of the value of the note issue was to be kept in rupee coins, securities of the Government of India and approved commercial bills. But, according to an amendment of the Reserve Bank of India Act, made in 1956, the proportional reserve system was abandoned and its place was taken over by the minimum reserve system. According to the new system, the note issued was to be backed up by foreign securities worth Rs.400 crores and gold coins worth Rs.115 crores. Before this amendment, the Reserve Bank of India used to evaluate its reserves of gold at Rs.21-3-10 per tola. But after this amendment, it started the evaluation of its gold stock at Rs.62-8-0 (Rupees sixty two and eight annas) per rupee in the I.M.F. was determined at this rate. Consequently, the gold reserves of the Bank which were formerly worth Rs.40 crores now become equivalent to Rs.115 crores. The Reserve Bank of India Act was amended once again on 31st October 1957. Under this amendment, the cover behind paper currency was fixed at Rs.200 crores. In other words, the entire note issue was to be backed up by gold, gold coins and foreign securities worth Rs.200 crores. At no time was this cover to fall below Rs.200 croes. This was the minimum limit of the reserves fixed under the above amendment. Besides, the value of gold and gold coins in this cover was not to be less than Rs.115 corres. Thus, according to the amendment of 1957, the amount of foreign securities in the cover was reduced from Rs.400 croes to Rs.85 crores. The amendment also provided that the value of foreign securities in the cover could fall even below Rs.85 crores in times of emergency with prior consent of the Government of India. Thus, the Bank adopted the minimum reserve system in place of the traditional proportional reserve system. The change introduced an element of elasticity in India's note issue. In fact, this system appears to

be quite appropriate for speeding up the process of economic growth in the country. The total amount of notes issued by the Bank stood at Rs.120,073 crores as against Rs.1,02,302 crores in 1994-95. The cover behind this note issue was as follows—gold bullion and gold coins Rs.13,751 crores; foreign securities Rs.10,200 crores; Rupee coins Rs.115 crores; Rupee securities of the Government of India Rs.96,041 crores.

2. The Reserve Bank of India as the Government Banker: The second main function of the Reserve Bank of India is to act as the banker to the Central and State Governments. It is in this capacity that the entire banking business of the Central and the State Governments is conducted by the Reserve Bank of India. The Reserve Bank of India receives and makes Payments on behalf of the Governments. The Reserve Bank of India collects money on behalf of the Central and State Governments and also makes payments in accordance with their instructions. It should, however, be remembered that the Reserve Bank of India gives no interest on Government's deposits. In 1991-92, the Reserve Bank of India had about Rs.205 crores with it as the deposits of the Central and the State Governments. The Reserve Bank of India floats Loans on behalf of the Governments. The Government of India and State Governments secure loans from the public through the Reserve Bank of India. The Bank acts as the agent of the Central and the State Governments in the matter of floatation of loans. The bank also keeps regular accounts of the public debts of the Central and the State Governments. The Bank pays the principal as well as the interest on public debts on behalf of the Central and the State Governments. The Reserve Bank of India extends only short-term loans to the Central and the State Governments. In other words, those loans must be repaid within a period of 90 days. The Reserve Bank of India is prohibited under the Act to extend loans for more than 90 days. In 1993-94 the Reserve Bank of India had given loans to the extent of Rs.12 crores to the State Governments. But no loan was outstanding so far as the Government of India was concerned.

3. Transfer of Government Funds: The Reserve Bank of India transfers Government funds from one place to another in its capacity as the banker to the Government.

4. Provision of Foreign Exchange: The Reserve Bank of India also makes arrangements for the supply of foreign exchange to the Central and the State Governments.

5. Economic Advice to the Governments: The Reserve Bank of India tenders from time to time advice to the Central and the State Governments on matters of currency, credit and other economic problems. This helps the concerned governments in the formulation of economic policies. The Reserve Bank of India levies no charges on the Central and the State Governments for

rendering the above services, the reason being that it pays no interest to the Governments, Central and State, on their deposits lying with it.

6. **The Reserve Bank of India is the Bankers' Bank:** In its capacity as the Central bank, the Reserve Bank of India also acts as the Bankers' Bank. It renders financial assistance to the scheduled banks in times of emergency.

7. **The Reserve Bank of India is the Lender of the Last Resort:** Under the Reserve Bank of India Act, 1934, every scheduled bank had to deposit cash reserves with the Reserve Bank of India equivalent to 5 per cent of its demand liabilities and 2 percent of its time liabilities. Later on, it was provided under the Banking Companies Act, 1949, that the non-scheduled banks should also maintain cash reserves with the Reserve Bank of India like the scheduled banks. According to an amendment of the Reserve Bank of India Act, made in 1956, the Reserve Bank of India could direct every scheduled bank to deposit cash reserves with it equivalent to 20 per cent of its demand liabilities and 8 per cent of its time liabilities. But according to an amendment of the Banking Companies Act, 1949, made in September 1972, the scheduled banks were required to deposit with the Reserve Bank of India only 3 per cent of their demand and time liabilities. The Reserve Bank of India was, however, given the power to raise this from 3 per cent to 15 per cent, if it considered it necessary. In August 1973, this was raised to 7 per cent but it was lowered down to 5 per cent on 27th June 1974. This was raised to 6 per cent on November 13, 1979. This percentage was further raised to 7 on September 11, 1981. Thus, the objective of the above amendment was to centralize the cash reserves of the scheduled banks with the Reserve Bank of India. For example if any bank was confronted with a crisis, it had the fullest right to seek financial assistance and the Reserve Bank of India could not refuse it on account of its being the lender of the last report. The Reserve Bank of India had granted loans equivalent to Rs.53,175 crores to the scheduled commercial banks in 1993-94.

8. **The Reserve Bank of India Controls the Credit Policy of the Member Banks:** Being the Central Bank, the Reserve Bank of India controls the creation of credit by the scheduled banks. It regulates banks' credit from time to time by adopting a variety of methods. For example, the Reserve Bank of India controls and regulates credit through the adoption of several measures, such as, the bank rate, open market operations, etc.

9. **The Reserve Bank of India extends General Control over the Scheduled Banks:** The Reserve Bank of India had been given extensive powers under the Banking Regulations Act, 1949 to control and regulate the activities of the scheduled banks. The Reserve Bank of India is empowered

to carry out the periodical inspection of the premises of the scheduled banks. The Bank is also authorized to tender advice to the scheduled banks. It also grants licenses for the establishment of new banks. It permits the existing banks to open branches at new places. No amalgamation of the banks is possible without the prior consent of the Reserve Bank of India. The Reserve Bank of India also enjoys the power to stop a bank from accepting fresh deposits from the public if its financial condition is found to be unsatisfactory. Likewise, a bank has to secure the approval of the Reserve Bank of India before going into liquidation. Besides, the Reserve Bank of India is also authorized to ask for weekly statement of affairs from the scheduled banks. It acts as the clearing house for the member banks.

10. The Reserve Bank of India maintains Stability of the Foreign Exchange Value of the Rupee: An important function of the Reserve Bank of India is to maintain stability of the exchange value of the Rupee. To achieve this objective, the Reserve Bank of India had been selling and purchasing foreign exchange at fixed rates right from its inception. The Bank had established the Exchange Control Department in September 1939 immediately after the outbreak of the Second World War. All foreign exchange transactions were handled by the Exchange Control Department. This department was granted wider powers under the Foreign Exchange Control act of 1947. India had become a member of I.M.F. on 1st March 1947. Before this, the Foreign Exchange Council Department of the Bank used to buy and sell Sterling at 1s. 6d. But after India became a member of the I.M.F. on 1st March 1947, the statutory link with the Sterling broke down. Up to September 1949 the Reserve Bank of India maintained the gold value of the Indian Rupee at 0.268691 gram with the approval of the I.M.F. But the Rupee was devalued by the Government on 19th September 1949. Its gold value was new reduced to 0.186621 gram. During the process, there was no change in the Sterling value of the India Rupee. It continued to remain stable at 1s. 6d. the reason was, the Indian Rupee had been devalued to the same extent as the British Pound-Sterling in September 1949. The Indian Rupee was devalued for the second time on 6th June 1966. The gold value of the Rupee now fell down to 0.118517 gram. After the devaluation of the U.S. dollar in February 1973 the Indian Rupee was linked with the British Sterling at 18.9677 Rupees per Sterling. This continued till 24th September 1975 when the Rupee was delinked from the British Pound Sterling. It was now linked to a basket of a number of selected currencies of the countries which were India's trading partners. After 24th September 1975 there was little stability in the exchange value of the Rupee. From 24th September 1975 to 30th June 1989 the exchange rate of the Rupee was changed 1224 times. At the present moment, the Reserve Bank of India buys and sells the currencies of those countries which are the members of the

I.M.F. The Reserve Bank of India buys and sells these foreign currencies at rates determined from time to time.

11. The Reserve Bank of India Controls Credit: Being the Central Bank, the Reserve Bank of India controls the volume of credit created by the member banks. It does so by resorting to several methods, such as, the bank rate, open market operations and variations in cash reserves and other methods. A detailed account of the various methods of credit control adopted by the Reserve Bank of India would be given in an ensuing section.

12. The Reserve Bank of India makes Provision for Agricultural Credit: As already said above, the Reserve Bank of India had established the agricultural credit department right in 1935. The main function of this department is to carry out research on problems connected with agricultural credit. Besides, this department tenders useful advice to the Government of India, the State Governments and the Cooperative Banks for the development of rural credit. The department also renders financial help to the Central and State Governments in the construction of the godown in different parts of the country.

13. The Reserve Bank of India acts as the Clearing House: Being the Central Bank, the Reserve Bank of India also performs the functions of a clearing house for the member banks. Thus, it facilitates the movement of funds among the affiliated banks.

14. Reserve Bank collects and publishes Economic Statistics: The Reserve Bank collects statistics pertaining to currency, credit, ban king, finance, agricultural and industrial production. It also publishes its conclusions in the form of periodical reports.

Ordinary Banking Functions of the Reserve Bank

The Reserve Bank of India in addition to its Central Banking functions also performs the following ordinary banking functions:

1. Acceptance of Deposits: The Reserve bank of India is prepared to accept deposits from the Government of India, the State Governments and even private individuals. But it pays no interest on such deposits.

2. Sale and Purchase of Commercial Bills of Exchange: The Reserve bank of India rediscounts commercial bills and promissory notes tendere3d by the scheduled banks. But the condition is that such bills and promissory notes tendered by the scheduled banks. But the condition is that such bills should mature within a period of 90 days. In other words, the Reserve Bank does not accept such bills of exchange as mature after 90 days. The rediscount rate on such bills of exchange is 10 per cent.

3. **Sale and Purchase of Agricultural Bills:** The Reserve Bank also rediscounts agricultural bills. But the condition is that such agricultural bills must mature within a period of 15 months. It should be remembered that the Reserve Bank gives special concessions in the rediscounting of agricultural bills. The commercial bills to be rediscounted must mature within 90 days. But the Reserve bank is prepared to allow a maturity period of 15 months in the case of agricultural bills.

4. **Giving of Loans and Advances:** The Reserve Bank grants ways and means advances to the Government of India and the State Governments. But these advances cannot be given for a period exceeding 90 days. Moreover, such ways and means advances can be given by the Bank only against gold, silver, securities, bills or promissory notes. In other worlds, the Bank is not authorized to give loans without security

5. **Borrowing:** The Reserve Bank can borrow from any scheduled bank in India or from any foreign bank. But the condition is that such borrowings cannot be for a period exceeding 30 days. Further, such borrowings cannot exceed the share capital of the Reserve bank.

6. **Power to open Accounts in Foreign Central Banks:** The Reserve Bank can open account in the World Bank or other foreign Central Banks for the proper performance of its functions. It can even appoint its agents in foreign countries.

7. **Miscellaneous Functions:** The Reserve Bank can also perform a large variety of miscellaneous functions. The Reserve Bank can keep in its custody, gold, silver, diamonds, securities, etc. The bank also enjoys the right to buy and sell gold, silver or coins made of gold and silver. The Reserve Bank can buy and sell the securities of the Central and State Governments. It can also buy and sell Sterling to the scheduled banks for a minimum amount of rupees one lakh.

6.3 ACHIEVEMENTS OF THE RESERVE BANK OF INDIA

The Reserve Bank has been existence for the past 60 years. During this period, it achieved certain success in its field of operations which may be set forth below:

1. **Cheap Money Policy:** During its career of 60 years, the Reserve Bank has endeavored to follow, as far as possible, a cheap money policy in the country. Till 1951, the bank rate continued to remain stable at 3 per cent. In fact, this cheap money policy produced beneficial effects on the economy. But in 1951, the bank rate was raised to 3½ per cent to control the inflationary pressures in the economy. Later on, several increases were made in the bank rate of the country. At the present moment (November 1986) the bank rate is 10 per cent. Taking into account the present inflationary conditions in

the economy, this bank rate is by no means a high rate. Thus, we can say that the Reserve Bank has 'more or less" followed a policy of cheap money during the past 55 years.

2. **Note-Issue Policy:** From 1935 to 1956, the Reserve Bank, issued paper currency according to the proportional reserve system. The Reserve Bank, thus, kept adequate metallic reserves behind its paper currency. The new system has brought about a sufficient degree of elasticity in the note-issue of the country. In fact, the minimum reserve system has proved to be quite useful for a developing country like India.

3. **Inflation Control Policy:** The Reserve Bank has also taken steps from time to time to control and regulate the inflationary pressures which have plagued the economy for the past several years. The bank has tried to control the price level in the country through its policy of Selective Credit Controls. It is true that the Reserve bank has not been able to achieve any significant success in its anti-inflation policy. But the inflationary situation would have been worse if the Reserve Bank had not been there to curb it.

4. **Stability in Interest Rates:** The Reserve Bank has endeavored to introduce stability in interest rates by expanding and contracting credit according to the commercial requirements of the country. It is true that there are seasonal fluctuations in interest rates even today in the Indian money market but such fluctuations are not as sharp as they used to be some years back. The credit for this achievement rightly belongs to the Reserve Bank. The Reserve Bank of India, taking into account the abnormal inflationary situation in the country, made a sharp increase in interest rates in July 1974, to be charged on bank loans and advances. The interest rate on time deposits was further hiked on February 28, 1981.

5. **Management of Public Debt:** As an agent of the Government, the Reserve Bank has done praiseworthy work in the management of public debt in the country. Besides, the Reserve Bank has saved the Government from financial difficulties by extending short-term loans from time to time.

6. **Reserve bank as the Bankers' bank:** The Reserve Bank, in its capacity as the lender of the last resort, has done useful service in giving loans and advances to the member banks at the time of crisis. The Bank has saved several affiliated banks from failure by giving them financial assistance at the time of difficulty.

7. **Industrial Financing:** The Reserve Bank has also rendered valuable service by arranging finance to large-scale, medium-scale and small-scale industries. As we have seen above, the Reserve Bank has rendered financial and organizational assistance in the establishment of the Industrial Finance Corporation, State Finance Corporations, and the Industrial Development Bank

of India. The Bank has, thus, removed a major lacuna of the Indian money market.

8. Agricultural Financing: The Reserve bank has made special provision for agricultural finance through its agricultural credit department. The Bank has also achieved significant success in this field. Further, the Reserve Bank has rendered valuable services in reorganizing and reinforcing the cooperative movement in different States of the country. The setting up on NABARD by the Reserve Bank on July 12, 1982 is a further testimony to its active and continuing interest in agricultural financing.

9. Cheap Remittance Facilities: The Reserve bank has provided cheap facilities to the Government, scheduled banks and the cooperative banks for the transfer of funds from one place to another. With the help of the Reserve Bank the member banks can get the funds transferred from one place to another at an insignificant expense.

10. Credit Control Policy: By resorting to different methods, the Reserve Bank has endeavored to control and regulate the volume of credit in the country. It has also achieved some success in this direction. As a result of the selective credit control policy of the Government, the speculative activities in agricultural products have been discouraged to some extent. The credit control policy of the Bank has also helped to check the prices of other essential goods.

11. Stability in the External Value of the Rupee: The Reserve bank has been particularly successful in achieving stability in the external value of the Rupee during the past 47 years. As is well known, the Sterling value of the Rupee had remained stable at 1s.6d. for the past several years. The credit for this external stability of the Rupee rightly belongs to the Reserve Bank. But the Government of India, through its own action, devalued the rupee on 6th June 1966. Even after this date there have not been any significant fluctuations in the exchange value of the Rupee. The Rupee's exchange value is now determined by the RBI from daily exchange rate movements of a basket of selected currencies of countries which are India's major trading partners. The external value of the Indian Rupee has, however, not been stable after 24th September 1975, when it was linked to a basket of major international currencies.

12. Banking Development: The Reserve Bank has also rendered valuable service in the proper development of banking within the country. The Bank by making use of its extensive powers, had laid the foundation of a well-organized banking system in the country. It has endeavored to strengthen and reinforce the banking structure of the country by encouraging the amalgamation of uneconomic and nonviable banking units in the country.

13. Establishment of the Bill Market: By implementing its bill market scheme in 1952, the Reserve Bank of India has tried to establish a well-organized bill market in the country. It has even achieved some partial success in this connection.

14. Clearing Arrangements: The Reserve Bank of India has made provision for clearing arrangement in about 32 crores in the country. This has simplified and facilitated inter-bank transactions in the country. Thus, the Reserve Bank of India has succeeded in popularizing, to a large extent, the use of cheques in the country.

15. Establishment of Indian Discount and Finance House: On 25th April 1988, the Reserve Bank of India took a courageous step by setting up Discount and Finance House of India (DFHI). This new institution deals with commercial and treasury bills with the objective of inducing greater liquidity in the money market.

16. Collection and Publication of Economic Statistics: The Reserve Bank of India collects from time to time statistics pertaining to money, credit, banking, cooperation, agricultural and industrial production, and brings out periodical reports based on such statistics. In fact, this function of the Reserve Bank of India has greatly helped the Government in analyzing and solving the economic problems of the country.

6.4 FAILURES OF THE RESERVE BANK OF INDIA

1. Lack of Coordination in the Money Market: The greatest failure of the Reserve Bank has been its inability to establish coordination in the activities of the major sectors of the money market. The indigenous bankers even today lie outside the purview of the control of the Bank. In fact, the lack of control by the bank over the indigenous bankers is not in the interests of the proper development of the banking in the country.

2. Lack of Uniformity in Interest Rates: A great diversity in Interest rates is to be found even today in different parts of the country on account of the lack of coordination in the money market. The indigenous bankers, the sahukars and the mahajans (who are not constituents of the organized banking sector) charge exorbitant interest rates on their loans and advances. The changes in the Bank rate produce no effects on their interest rates. In fact, this can be construed as a major failure of the Reserve Bank.

3. Failure to Develop the Bill Market: It is true that the Reserve bank implemented its Bill Market Scheme in 1952 to develop the bill market in the country. But despite this, there has not been a sufficient development of the bill market in the country. Even today there is a great dearth of good and discountable bills of exchange in the money market.

4. **Inadequate Development of Agricultural Credit:** Though the Reserve bank has taken several steps for the expansion of agricultural credit, yet it has not been possible to bring about an adequate development of this credit in the country. Sufficient credit at reasonable rates is not available to the farmers for agricultural purposes even today.

5. **Inadequacy of Banking Facilities:** Though there has been a considerable expansion of banking facilities during the past few years and new bank branches have been opened at several places, yet the present banking facilities are not adequate taking into account the huge size of the country and its population. Even today, there are places in the country where banking in conspicuous by its absence. The Reserve bank has not succeeded in removing this lacuna in the banking system.

6. **Instability in the Internal Value of the Rupee:** The greatest failure of the Reserve Bank has been its inability to stabilize the internal and uninterrupted inflation in the country during the past several years, there has been a rapid rise in the price level or a steep decline in the internal value of the Rupee. This inflation has produced adverse repercussion on the economic situation within the country. Though the Reserve Bank has adopted several anti-inflationary measures, it has not been able to make any significant impact on the monetary situation in the country. The internal value of the Rupee continues to decline as before.

7. **Failure to secure Equitable Share for the Indian Banks in Foreign Exchange Business:** Though the Indian commercial banks have been trying during the past few years to gain an entry into the foreign exchange business, they have not been able to achieve any significant success in this direction. The foreign exchange banks continue to enjoy almost complete monopoly of the foreign exchange business as before. The Reserve Bank has failed to secure to the Indian banks a proper and an equitable share in the foreign exchange business of the country.

8. **Failure to save banks from Banking Crises:** When the Reserve Bank was established in 1935, it was hoped that it would extend its protection to the member banks against banking crises from time to time. But, unfortunately this hope has not been fulfilled. Immediately after the establishment of the Reserve Bank, the Travancore National and Quillon Bank collapsed in the absence of timely assistance from the Reserve bank. Between 1939 and 1946, nearly 444 banks, big and small, failed in the country. The Reserve bank could not save them from failure. It argued that it could not protect theses banks from failure on account of inadequate powers granted to it under the Act. The Banking Companies Act, 1949 tried to remove this lacuna by giving extensive powers to the Reserve Bank to carry out the

periodical inspections of the member banks. Despite this, the Palai Bank and the Lakshmi Bank failed in recent years and the Reserve Bank did nothing to save them from this disaster.

9. **Reserve Bank, a Toothless Watchdog:** Though the Reserve Bank of India has been given wide powers under the law, yet the truth is that it has turned out to be a toothless watchdog in performing its role as the coordinator, controller and regulator of India's banking system. Although in its capacity the Central Monetary Authority of the country, the Reserve Bank is the custodian of India's banking system, its performance in this context is hardly encouraging. Under its benign dispensations, there has been continuous erosion in the profitability of the member banks. The reasons are all well-known-increase in operating costs, inefficiency of the bank staff, increasing number of bank frauds, and fall in interest earnings. Irregularities in loan recoveries and locking up bank funds in sick industrial undertakings are other important reasons for the deterioration of bank profitability in recent years.

The failure of the Reserve Bank in the monetary sector was still more disappointing. During the past 32 years the Reserve bank had extended bank credit on a large scale to the Government of India for the implementation of the Five-Year Plans. It was this bank credit which opened the floodgates of inflation in the country. The country's economy suffered an irreparable damage. The Reserve bank did not have the courage to refuse bank credit to the Government, though the maintenance of the stability of the monetary system was the statutory responsibility of the Reserve bank of India.

Check your progress

Fill in the blanks:

1. Central bank is the ______________ institution in any financial system.
2. Reserve Bank controls _________________ in the financial system.
3. The Reserve Bank of India enjoys monopoly with respect to _________.
4. Regulation of ________________________ is one of the functions of the central bank.
5. Reserve Bank of India is also known as the lender of ____________.
6. Two important institutions promoted by the Reserve Bank of India in the realm of rural and agricultural finance are ______________ and ____________.

Let us sum up

As the central banking authority of the country, the Reserve Bank of India is the banker's bank, their friend, philosopher and guide. The Reserve Bank of India was originally constituted with a share capital of Rs.5,00,00,000 divided

into Rs.5,00,000 fully paid up shares of Rs.100 each. For a successful operation, the country was divided into four areas, ie, Mumbai, Kolkotta, Delhi and Chennai. After independence, the entire capital was acquired by the central govt. and the Reserve Bank was nationalized on 1st January, 1949.

The affairs f the bank are controlled by a central board of directors, which consists of governor and directors nominated by the central government. There are also local boards, consisting of five members appointed by the central government, for a term of four years, in the four regions of the country. The Reserve Bank of India have now opened many offices at Trivandrum, Ahmedabad, etc, for effective monetary control.

The Reserve Bank of India performs several functions, typical to a central bank. The supervisory and regulatory functions are note issue, credit control, statutory regulation and exchange control. It is the lender of last resort and provide refinance facilities. By stipulating regulations to the commercial banks, it provides agricultural finance, industrial finance, export finance. The Reserve Bank has many achievements to its credit, but has been unsuccessful in many areas.

Glossary

Central Bank : The apex institution in the financial system of a country.

Note issue : Issue of paper currency as a medium of exchange for value, subject to certain conditions stipulated by the Reserve Bank.

Scheduled Bank : A bank included in the schedule II of the RBI Act, 1934.

Answer to check your progress

Fill in the blanks:

1. apex 2. credit 3. note issue 4. currency 5. last resort
6. National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRB's).

Model Questions

1. Explain the organization and structure of the Reserve Bank of India.
2. Describe the functions of the Reserve Bank of India.
3. Explain the achievements and failures of the Reserve Bank of India.

Unit 7

SALIENT FEATURES OF THE BANKING REGULATION ACT 1949

STRUCTURE

Overview

Learning Objectives

7.1 Banking regulation Act of 1949

7.2 Important Provisions

Let us sum up

Glossary

Answers to check your progress

Model questions

OVERVIEW

Banking is an industry where the large chunk of working funds is derived mainly from deposits received from depositors. In order to have an organic and orderly growth of the banking industry, it is imperative that the Banking System has in place sufficient safeguards by way of different enactments/ legislations to protect the interests of the depositors as also to provide for a strong and sustainable Banking System. In our country, the demand for banking legislation had its origin in the spate of banking failures witnessed during the years 1913-1931. As a matter of fact the terms of reference of the Indian Central Banking Enquiry Committee (1929-31) included "the regulation of Banking with a view to protecting the interests of the public". The committee did analyze the causes of a large number of failures in the Banking industry and came to the conclusion that the following factors were responsible for the failures of the Banks-

a. incomplete of directors;

b. bad and speculative investments;

c. combinations of trading and banking;

d. combination of trading and banking;

e. injudicious advances;

f. insufficient paid up capital and reserves;

g. poor liquidity of funds

h. unrestricted loans to directors and to concerns in which they are interested and

i. mismatch of maturity of deposits and advances.

The earliest attempt at bringing a banking legislation was the amendment made to the Indian Companies Act, 1936. This amendment took care of certain important recommendations of the Central Banking Enquiry Committee. In course of time, these provisions were found to be inadequate and proved difficult for implementation. In the year 1939, though the Reserve Bank of India forwarded a proposal for bringing a comprehensive banking legislation, the government could not act concretely for the reason that it was preoccupied with the aftermath of war as also lack of unanimity of opinion on the subject. The years that followed witnessed a large number of banks appearing on the scene. And naturally the need for a controlling legislation was felt all the more acute.

LEARNING OBJECTIVES

The Banking Companies Act for the regulation and control of Banking came in to force on 16th March 1949, it having been passed by the legislature in February, 1949. The name of the Act got changed in 1966, when it acquired the name the Banking Regulation Act, 1949. Actually, the Act looks like a control tower of the Indian Banking System.

This chapter highlights the salient features of the Banking Regulation Act.

7.1 BANKING REGULATION ACT OF 1949

The banking Regulation Act, 1949 has ten parts, each dealing with a specific topic. Let us have a quick glance of the scheme of the Act.

Sl.No	PART	TOPIC	SECTIONS COVERED
1.	I	Preliminary	1 to 5A
2.	II	Business of Banking Companies	6 to 36A
3.	II a	Control over Management	36AA to 36AC
4.	IIb	Prohibition of certain Activities in relation to Banking Companies	36AD
5.	IIc	Acquisition of the under-takings of banking companies in certain cases	36AE to 36AJ
6.	III	Suspension of business and winding up of banking companies	36B to 45

Sl.No	PART	TOPIC	SECTIONS COVERED
7.	IIIa	Special provisions for Speedy disposal of Winding up proceedings	45A to 45X
8.	IIIb	Provisions relating to certain operations of Banking Companies	45Y to 45ZF
9.	IV	Miscellaneous	46 to 55A
10.	V	Application of the act to Co-operative Bank	56

The Act as it stands now provides for the following controls-

a. Minimum paid-up capital
b. Classification of Companies into Banking and Non-Banking Companies
c. Licencing of Banking Companies
d. Restrictions on Branch Banking
e. Maintenance of cash Reserves
f. Maintenance of assets in India
g. Minimum liquid assets ratio
h. Prohibition of common directors
i. Restriction on payment of dividend and transfer of a certain percentage of profit to the reserve fund
j. Restrictions on nature of subsidiary companies
k. Accounts and Balance Sheet
l. Inspection of Banking Companies
m. Suspension of Business and Winding up
n. Schemes of Arrangement and Amalgamation and
o. Compulsory amalgamation of Banking Companies

The Banking Regulation Act 1949 applies to the following categories of banks.

p. Nationalised Banks
q. Non-Nationalised Banks
r. Co-operative Banks

7.2 IMPORTANT PROVISIONS

SECTION 6: deals with the forms of business in which Banking Companies may engage.

SECTION 7: relates to use of words "Bank", "Banker" or "Banking Company".

No Company other than a Banking Company shall use as part of its name or in connection with its business, any of the words "Bank", "Banker" or "Banking" and no company shall carry on the business of Banking in India unless in India it uses as part of its name at least one of such words. No firm, individual or group of individuals shall for the purpose of carrying on any business, use as part of its or his name, any of the words "Bank", "Banking" or "Banking Company".

SECTION 8: speaks about prohibition of trading by Banking Company.

No Banking Company, notwithstanding anything contained in Section 6 or in any contract, shall directly or indirectly engage in any trade of goods except in connection with the realization of security given to or held by it.

SECTION 9: deals with disposal of non-banking assets.

Notwithstanding anything contained in Section 6, no banking company shall hold any immovable property, howsoever acquired, except such as is required for its own use for any period the Banking Company.

SECTION 10: prohibits employment of managing agents and places restrictions on certain forms of employment.

★ who is or at any time has been adjudicated insolvent or has suspend payment or has compounded with his creditors or who is or has been convicted by a criminal court of an offence involving moral turpitude or

★ whose remuneration are part of whose remuneration takes the forms of commission or of a share in the profits of the company.

However, the above provision shall not apply to the payment by a banking company of:

★ Any bonus in pursuance of a settlement or award arrived at or made under any law relating to Industrial disputes or in accordance with any scheme framed by such banking company or in accordance with the usual practice prevailing in banking business.

★ Any commission to any broker (including guarantee broker), cashier contractor, clearing and forwarding agent, auctioneer or any other person, employed by the banking company under a contract otherwise than as a regular member of the staff of the company or

★ Whose remuneration is in the opinion of the Reserve Bank of India, excessive.

Again, Banking Company shall not be managed by a person

★ a subsidiary of the banking company or

★ a company registered under Section 25 of the Companies Act, 1956

(I.e. Companies for Charitable purpose or for promotion of art, Science, religion etc.) Or

★ who is engaged in any other business or vocation or

★ Whose term of office as a person managing the company is for period exceeding five years at any one time.

Provided that the term of office of any such person may be renewed or extended by further periods not exceeding five years on each occasion, subject to the condition that such renewal or extension shall not be sanctioned earlier than two years from the date on which it is to come into force.

Provided where the term of office of such person is for an indefinite period, such term unless it otherwise comes to an end earlier, shall come to an end immediately on an expiry of five years from the date of his appointment or on expiry of three months from the date of commencement of Section 8 of the Banking Laws (miscellaneous provisions) Act, 1963, which-ever is later. The above provision shall not apply to a director other than the managing director of a banking company, by reason only of his being such director.

SECTION 10A: specifies that Board of Directors to include persons with professional or other experience. The Section provides that not less than 51% of the total numbers on the Board of Directors of a banking company shall consist of persons who satisfy the following conditions:

★ They shall have special knowledge or practical experience in respect of one or more of the following matters, namely: accountancy, agriculture, and rural economy, co-operation, economics, fiancé, law, and small scale industry. Any other matter the special knowledge or practical experience in which would in the opinion of the Reserve Bank, be useful to the banking company. Provided that out of the aforesaid number of directors, not less than two shall be personal having special knowledge or practical experience in respect of agriculture and rural economy, co-operation or small scale industry.

★ They shall not....have substantial interest in or be connected with, whether as employee, manager of: (a) any company but being a company registered under section 25 of the companies Act 1956 or (b)any firm which carries on any trade commerce or industry and which, in either case, is not a small scale industrial concern, or (c) be proprietors of any trading, commercial or industrial concern not being a small scale industrial concern.

Where the Reserve Bank is of the opinion that the composition of the Board of Directors of a banking company is such that it does not fulfill the above requirements it may after giving to such banking a reasonable opportunity of being heard, by an order in writing, direct the banking company to reconstitute

its Board of Directors afresh. If within two months from the date of receipt of that order, the banking company does not comply then 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.

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. He shall not be eligible to be reappointed as director of such banking company for a period of 4 years from the date of his ceasing to be the chairman whole time director.

SECTION 10B: provides that Banking Company is to be managed by a whole time Chairman. Every banking company shall have a whole time chairman, who will be a professional banker and not an industrialist. He shall be entrusted with the management of the whole of the affairs of the banking company subject to the superintendence, control and guidance of the Board of Directors. His appointment shall be made by the banking company with the prior approval of the Reserve Bank. He shall hold office for a period not exceeding five years but shall be eligible for re-appointment. The Reserve Bank shall have the power to remove from office the chairman of a banking company, whom it considers to be an unfit and improper person and appoint a suitable person in his place after giving reasonable opportunity of being heard both to the chairman as well as to the banking company.

A person shall be disqualified for being a chairman of a banking company, it he...

a. Is a director of any company other than (i) a company which is subsidiary of the banking company,(ii) a company registered under section 25 of the Companies Act.

b. Is a partner of any firm which carries on any trade, business or industry or

c. Has substantial interest in another company or firm or

d. Is a director, manager, partner or proprietor of any trading, commercial or industrial concern, or

e. Is engaged in any other business or vocation.

A chairman of the Board of directors of a banking company may, by writing under his hand addressed to the company resign his office but shall continue in office until successor assumes office. Notwithstanding anything contained in this section, the Reserve Bank may, if in its opinion it is necessary in the public interest so to do, permit the chairman to undertake such part-time honorary work as is not likely to interfere with his duties as such chairman.

SECTION 10BB: POWER OF THE RESERVE BANK TO APPOINT CHAIRMAN OF BANKING COMPANY. In case the position of a Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director of a Banking Company becomes vacant and if the interests of the bank are likely to be adversely affected because of the continuance of the vacancy, the Reserve Bank of India may appoint any person (eligible under Section 10B) to the post. Such a person shall be deemed to be the director of Banking Company, so long as he holds the post, even though he is not a director already.

He can hold the post for a period not exceeding three years or as may be specified by the Reserve Bank of India and is eligible for reappointment.

SECTION 10C: provides that Chairman and certain directors are not to be required to hold qualification shares.

SECTION 11: REQUIREMENT AS TO MINIMUM PAID-UP CAPITAL AND RESERVES

The Provisions relating to the requirement of minimum paid-up capital and reserves are captured in the following table:

TABLE

			Aggregate value of paid up capital and reserve
	I	**INCORPORATED IN INDIA**	**Rs.**
A	i	For a banking company incorporated in India having places of business in More than one State.	5,00,000
	ii	If any such place or places of business is or are situate in the City of Bombay or Calcutta or both.	10,00,000
B		If all places of business in one State but none of which in Bombay City or Calcutta:	
	i	For principal place of business is one State (except in City of Bombay and Calcutta)	1,00,000
			Aggregate value of paid-up capital & reserve
	ii	For each other place of business in the same district plus	10,000
	iii	For each place of business situated outside that district	25,000
		Subject to a total of	5,00,000
	iv	For having only one place of business	50,000
		If all places of business in one State:	
C	i	One or more of which is/are in the city of Bombay or Calcutta plus	5,00,000

			Aggregate value of paid-up capital & reserve
	ii	In respect of each place of business situated outside the city of Bombay or Calcutta	25,000
		Subject to a total of	10,00,000
		II. INCORPORATED OUTSIDE INDIA	
	i	If it has no place of business in Bombay City or Calcutta	15,00,000
	ii	If it has a place of business in Bombay City or Calcutta or both	20,00,000

A foreign bank is required to deposit with the Reserve Bank of India, either in cash or in the form of unencumbered approved security to the extent specified above.

Foreign banks are required to deposit with the Reserve Bank of India an amount calculated at 20% of the annual profit in respect of business transacted in India.

SECTION 12: Regulation of paid-up capital, subscribed capital, authorised capital and voting rights of shareholders

i. The subscribed capital of Banking Company should not be less than one half of its authorized capital.

ii. The paid-up capital should not be less than one half of the subscribed capital.

iii. The capital should consist of equity shares only (or equity shares and such preference shares as were issued prior to 1st July 1944)

iv. No person holding shares in Banking Company shall in respect of any shares hold by him exercise voting rights in excess of 10% of the total voting rights of all the shareholders of the Banking Company.

SECTION 12A: Election of new directors. The Reserve Bank of India may require any Banking Company to call for a general meeting of the shareholders of the company at any time, but not less than two months from the date of the order, with a view to elect fresh directors in accordance with the provision of the Act.

SECTION 15: Restrictions as to payment of dividend. A banking company cannot pay dividend on its shares until all its capitalized expenses including preliminary expenses, organization expenses, share selling commission, brokerage, amounts of lasses incurred and any other item of expenditure not represented by tangible assets have been completely written off.

But a banking company need not write off:

a. Depreciation in the value of its investments in approved securities in any case where such depreciation has not been actually capitalized or otherwise accounted for a loss.

b. Depreciation in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company; and

c. Bad debts in any case where adequate provision for such bad debts has been made to the satisfaction of the auditor of the banking company.

RECENT CHANGES

In the context of changes envisaged in the holding of equity of public sector banks consequent upon the issue of shares to the public, effective May 1995, public sector banks were subjected to prior approval of the Reserve Bank of India for payment of interim dividend, dividend higher than 25% and in cases of non-fulfillment of four stipulated conditions:

a. Compliance with the provisions of Section 15 of the Banking Regulation Act, 1949.

b. Proposed dividend being not more than 25% of current years profit.

c. Compliance with the extant regulations on transfer of profits to statutory reserves setting up of required provisions and

d. Observance of prudential accounting norms and capital adequacy requirements.

SECTION 16: Prohibition of common directors This Section prohibits the appointment of any person as a director, who is a director of

a. any other banking company or

b. companies which among themselves are entitled to exercise voting rights to excess of 20% of the total voting rights of all the shareholders of the banking company.

These provisions, however, do not extend to persons appointed as directors by the Reserve Bank of India.

SECTION 17: Reserve fund Under Section 17 of the Banking Regulation Act, 1949, every banking company incorporated in India must create a Reserve Fund and transfer a sum equal to not less than 20% of its net profits. However, the Central Government is empowered to exempt any banking company from the requirement on the recommendation of the Reserve Bank of India. Such exemption will be allowed only.

a. When the amounts in the Reserve Fund and the share premium account are equal to the paid-up capital of the banking company and

b. When the Central Government feel that its paid-up capital and reserves are adequate to safeguard the interests of its depositors.

.f a banking company appropriates any sum from the Reserve Fund or the share premium account, it should report the fact to Reserve Bank of India within 21 days explaining the circumstances leading to such appropriation.

SECTION 18: Cash reserve. As per the provisions of the section, every banking company not being a scheduled bank (A NON-SCHEDULED BANK) has to maintain in India, by way of cash reserves with itself or in current account with the Reserve Bank of India or by way of net balance in current accounts or in one or more of the aforesaid ways, a sum equivalent to at least 3% of its total demand and time liabilities as on the last Friday of the second preceding fortnight and to submit to the Reserve Bank of India, before the twentieth day of every month, a return showing the amount so held on alternate Fridays during a month with particulars of its demand and time liabilities on such Fridays.

It may be recalled that according to Section 42 (1) of the Reserve Bank of India Act, every SCHEDULED BANK is required to maintain this cash reserve ONLY WITH the Reserve Bank of India. The discretion to keep cash reserve with itself or other banks is not allowed to Scheduled Banks.

SECTION 19: Restriction on nature of subsidiary companies. A banking company shall not form any subsidiary company except a subsidiary company formed for one or more of the following purposes, namely:-

a. the undertaking of any business, which under clauses (a) to (o) of the sub-section (1) of Section 6, is permissible for a banking company to undertake, or

b. with the previous permission in writing of the Reserve Bank of India, the carrying on of the business of banking exclusively outside India, or

c. the undertaking of such other business, which the Reserve Bank of India may, with the prior approval of the Central Government, consider to be conducive to the spread of banking in India or to be otherwise useful or necessary in the public interest.

Further, in terms of sub-section 2 of Section 19, save as provided in sub-section 1, no banking company shall hold shares in any company, whether as a pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid-up share capital of that company, or its own paid-up share capital and reserves, whichever is less.

SECTION 20: Restrictions on loans and advances. This section imposes certain restrictions on the loans granted by banks to persons connected with their management. This section as amended by the Amending Act of 1968 and as it presently stands is as follows:

1. No banking company can grant loans and advances on the security of its own shares.
2. The banking company should not enter into any commitment for giving any loan or advance to:
3. Any of its directors.
4. To a firm in which any of its directors is interested as partner, manager employee or guarantor
5. To a company of which any of the directors of the banking company is a director, manager, guarantor or
6. To any individual with whom any of its directors is a partner or a guarantor.

Thus not only grant of loans but even commitment to grant a loan to any director or director-connected firms, companies or individuals is prohibited. Any such loan granted already must be recovered before the expiry of one year from the commencement of the Act (1-2-1969) Sub section 3 prohibits any remission of such loan without Reserve Bank of India's approval.

SECTION 20A: Restrictions on power to remit debts. Notwithstanding anything to the contrary contained in Section 293 of the Companies Act, 1956, a banking company shall not, except with the prior approval of the Reserve Bank of India, remit in whole or part any debt due to it by

a. any of its directors or
b. any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor or
c. any individual, if any of its directors is his partner or guarantor.

SECTION 21: Power of reserve bank to control advances by banking companies. Under Section 21, the Reserve Bank of India enjoys wide powers. It is empowered to issue directions to a banking company to determine the policy in relation to advances to be followed by banking companies either generally or by any of them in particular.

Such direction may relate:

a. to the purpose for which any advance may or may not be made.
b. the margin to be maintained in the case of secured advances.
c. the maximum amount of advance to any one company, firm, individual or association of persons.

d. the maximum amount upto which guarantees may be given by the banking company on behalf of any one company, firm etc. and

e. the rate of interest and other terms and conditions on which such advances are made or guarantees given.

When a policy on these matters is determined by the Reserve Bank of India, ali banking companies or the concerned banking company must follow it.

The Reserve Bank of India has been exercising this power quite frequently by using directives in the nature of selective credit control.

SECTION 21A: Rates of interest charged by banking Companies not to be subjected to scrutiny by courts. A transaction between a banking company and its debtor shall not be reopened by any court on the ground that the rate of interest charged by the banking company in respect of such transaction is excessive, notwithstanding any provision contained in any other Act.

SECTION 22: Licensing of banking companies. According to Section 22, every banking company should hold a license issued by the Reserve Bank of India. The Reserve Bank of India can issue a license only if it is satisfied with regard to the following conditions after an inspection of the books of the banking company.

a. The banking company must be in a position to pay its present or future depositors in full as their claims accrue. It means the liquid and other readily realizable assets must be sufficient to meet the claims of its depositors.

b. The affairs of the banking company must not be conducted in a manner detrimental to the interest of the depositors.

c. In the case of foreign banks, the Reserve Bank of India should be satisfied that carrying on of a banking business by the foreign bank is in the public interest and that the government of the country in which it has been incorporated does not discriminate against any banking company registered in India.

The Reserve Bank of India can cancel the licence already granted to a banking company in case any of the above conditions is violated or the company ceases to carry on the banking business.

SECTION 23: Restrictions on opening of new and transfer of existing places of business as per the provision of this Section, every banking company shall obtain prior permission for opening new branches or for changing the location of the existing branches, either in India or overseas. This stipulation is enforced with a view to avoid undue concentration of branches as also to ensure that there is no indiscriminate branch expansion.

SECTION 24: Maintenance of percentage of assets According to Section 24 (2A) of the Banking Regulation Act, every banking company India whether scheduled or nonscheduled, is required to maintain in India in cash, gold or unencumbered, approved securities an amount which is not less than 25% of the total of its demand and time liabilities in India. This is known as Statutory Liquidity Ration (SLR). The Reserve Bank of India is empowered to increase this ratio. For calculating the SLR, the following liquid assets are taken into account:

a) Cash in hand in India.

b) Balances in current account with the State Bank of India and its associates.

c) Balance maintained with the Reserve Bank of India in excess of the minimum cash reserve requirements.

d) Investments in Government Societies, treasury bills and other approved securities in India.

In this connection, the following aspects need emphasis:

e) Gold and unencumbered approved securities must be valued at a price not exceeding the current market price.

f) Approved securities refer to securities which the trustees are allowed to invest trust money under Section 20 of the Indian Trust Act.

g) Unencumbered approved securities include those lodged with other institutions for securing an advance to the extent to which such securities have not been availed of.

Liabilities in India do not include the paid-up capital or the reserves or credit balance in profit and loss account or any advance taken from the Reserve Bank of India, Industrial Development Bank of India or any other bank notified by the Central Government. It must be remembered that the amount of liquid assets including cash in addition of the statutory reserves required to be maintained under section 42 of the Reserve Bank of India Act 1934. The present SLR is 25%.

SECTION 25: Assets in India. The assets in India of every banking company at the close of business on the last Fridays of every quarter or, if that Friday is a public holiday under the Negotiable Instruments Act, 1881, at the close of the business on the preceding working day, shall not be less than seventy-five percent of its demand and time liabilities in India.

SECTION 26: Return of unclaimed deposits. Every banking company shall, within thirty days after the close of each calendar year submit a return in the prescribed form and manner to the Reserve Bank of India as at the end of

such calendar year of all accounts in India which have not been operated upon for ten years.

SECTION 27: Monthly returns and power to call for other returns and information. Every banking company shall, before the close of the month succeeding that to which it relates, submit to the Reserve Bank of India a return in the prescribed form and manner showing its assets and liabilities in India as at the close of business on the last Friday of every month or if that Friday is a public holiday under Negotiable Instruments Act, 1881, at the close of business on the preceding working day. Apart from the above, the Reserve Bank of India may at any time require such statements and information to be given by any banking company as it may specify. Again, information regarding investments as well as the classification of its advances in respect of industry, commerce and agriculture may be required to be furnished by the Banking Company, every half year, if it is considered necessary by the Reserve Bank of India.

SECTION 29: Accounts and balance sheet. At the expiration of each calendar year, every banking company incorporated in India, in respect of all business transacted by it and through its branches in India, shall prepare a balance sheet and a profit and loss account as on the last working day of the year in the forms set out in the Third schedule or as near to there as circumstances admit.

The balance sheet and profit and loss account as on the last working day of the year and in the forms set out in the Third schedule or as near there to as circumstances admit.

The balance sheet and profit and loss account shall be signed:

a. in the case of a banking company incorporated in India, by the manager or the principal officer of the company and where there are more than three directors of the company by at least three of those directors, or where there are not more than three directors, by all the directors, and

b. in the case of a banking company incorporated outside India, by the manager or principal officer of the company in India.

The provisions of the Companies Act, 1956, relating to the Balance Sheet and Profit and Loss Account of a company shall also be applicable to the profit and loss account and Balance Sheet of a banking company, in so far as they are not inconsistent with the provisions of this Act.

SECTION 30: Audit The Balance Sheet and Profit and Loss Account prepared in accordance with Section 29 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies. Before appointment, reappointment or removal of any auditor, every banking company

shall obtain prior approval of the Reserve Bank of India. Further, the Reserve Bank of India can order for special audit of a banking company, if it is of the opinion that it is in the public interest or in the interests of the company or in the interests of the depositors. The auditor shall comply with the directions given by the Reserve Bank of India and shall submit a report of the audit to the Reserve Bank of India and also to the company. The auditor shall have the powers and exercise the functions as specified in Section 227 of the Companies Act, 1956.

Apart from the above, the auditor is required to state in his report:

a. whether or not the information and explanations required by him have been found to be satisfactory,

b. whether or not the transactions of the company which have come to his notice have been within the powers of the company;

c. whether or not the returns received from branch offices of the company have been found adequate for the purposes of his audit;

d. whether the profit and loss account shows a true balance of profit or loss for the period covered by such account;

e. any other matter which he considers should be brought to the notice of the shareholders of the company.

SECTION 31: Submission of returns. The Accounts and Balance Sheet as referred to above, together with the auditor's report shall be published in the prescribed manner and three copies thereof, shall be furnished as Returns to the Reserve Bank of India within three months from the end of the period to which they refer. The Reserve Bank of India may extend the above period of three months by a further period of not exceeding three months.

SECTION 32: Copies of balance sheets and accounts to be sent to registrar the copies of such accounts and balance sheet and of the auditor's report shall be sent by the banking company to the Registrar of Companies, at the same time, when it sends the same to the Reserve Bank of India.

SECTION 33: Display of audited balance sheets by companies incorporated outside India. Every banking company incorporated outside India is required, not later than the first Monday in August of the year in which it carries on business, display in a conspicuous place in its principal office and in every branch office in India a copy of its last audited balance sheet and profit and loss account prepared under Section 29. It shall keep them so displayed till they are replaced by subsequent balance sheet and profit and loss account.

SECTION 35: Inspection. The Reserve Bank of India at any time either by itself or on being directed by the Central Government shall cause an inspection to be made by one or more of its officers of any banking company and its

books and accounts. The Reserve Bank of India shall supply to the banking company, a copy of its report on such inspection. Every director or other officer of the banking company shall pro9duce all such books, accounts and documents as required by the Inspecting Officer. A person making inspection may examine on oath any director or other officer of the banking company. If the Central Government, after considering the report is of the opinion that the affairs of the banking company are being conducted to the detriment of the interests of its depositors, it may, after giving an opportunity of being heard, to the banking company, may order in writing

a. prohibit the banking company from receiving fresh deposits;

b. direct the Reserve Bank of India to apply under Section 38 for the winding up of the company.

Apart from the inspection provided under Section 35, the Reserve Bank of India can undertake inspection of a banking company in terms for the purposes of the following sections:

SECTION 11: Requirement as to minimum paid up capital and reserves.

SECTION 22: Licensing of banking companies.

SECTION 23: Restrictions on opening of new and transfer of existing places of business.

SECTION 37: Suspension of business.

SECTION 38: Winding up by high court.

SECTION 44: Power of high court in voluntary winding up.

SECTION 44A: Procedure for amalgamation of banking companies.

SECTION 45: Power of reserve bank to apply to central

Government for suspension of business by banking company and prepare scheme of reconstitution or amalgamation

SECTION 35A: Power of the reserve bank to give directions.

a. Where the Reserve Bank of India is satisfied that:

In the public interest; or

In the interest of banking policy; or

To prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or

To secure the proper management of any banking company generally;

it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

b. The Reserve Bank of India may, on representation made to it or on its own motion, modify or cancel any direction issued under sub-section (1), and in so modifying or canceling any direction may impose such condition as it thinks fit, subject to which the modification or cancellation shall have effect.

SECTION 35B: Amendments of provisions relating to appointments of managing directors etc. to be subject to previous approval of the reserve bank. Amendment of provisions relating to number of directors, remuneration, appointment, reappointment, termination etc., of Chairman, Managing Director or any other Director or any Chief Executive shall not have effect unless approved by the Reserve Bank of India.

Similarly, an appointment, reappointment, termination of any of the above said officials of the company shall have effect only with the approval of the Reserve Bank of India.

SECTION 36: Further powers and functions of the reserve bank

The Reserve Bank of India may –

1. Caution or prohibit companies generally or any banking company in particular against entering into any particular transaction or class of transactions and generally give advice to any banking company;
2. May assist, subject to provisions of this Act, on a written request of a banking company, in proposals for amalgamation of such banking company.
3. Give assistance to any banking company by means of grant of loan or advance, in terms of the provisions of the Reserve Bank of India Act.
4. In cases where it is satisfied that in the public interest or the interest of the banking policy or preventing the affairs of the banking company, being conducted in a manner detrimental to the interests of the banking company or its depositors. It is necessary to do so, by order in writing and on such terms and conditions as may be specified, require the banking company –
   i. to call a meeting of its directors for the purpose of considering any matter;
   ii. to require an officer of the banking company to discuss any matter with an officer of the Reserve Bank of India;
   iii. to depute one or more of its officers to watch the proceedings of any meeting of the Board of Directors of the banking company or of any committee or of any other body constituted by it. The officers so deputed shall have to be given an opportunity to be heard at such meetings, and they shall send a report of such proceedings of the Reserve Bank of India;

iv. to required the Board of Directors, committee etc., to give in writing all notices of and other communications relating to the meetings;

v. to appoint one or more officers to observe the manner in which the affairs of the banking company or of its offices or branches are being conducted and make a report thereon;

vi. to require the banking company to make such changes in the management and within such time as the Reserve Bank of India considers necessary.

The Reserve Bank of India shall make an annual report to the Central Government on the trend and progress of Banking in the country with particular reference to its activities under clause 2 of Section 17 of the Reserve Bank of India Act 1934.

The Reserve Bank of India may appoint such persons at such places as it may feel necessary to scrutinize the statements and information furnished by the banking companies and also to ensure efficient performance of its functions under the Act.

SECTION 36AA: Power of reserve bank to remove managerial and other personnel from office Where the Reserve Bank of India is satisfied that in the public interest or for preventing the affairs of a banking company being conducted in a manner detriment to the interests of the depositors or for securing proper management of the banking company, it is necessary to do so, it may by order remove any chairman, director, chief executive or other officer or employee of the banking company. Before the order of removal is communicated, an opportunity of being heard shall be given to the concerned person.

If the Reserve Bank of India feels that it would be detrimental to the interests of the depositors or the banking company to delay the removal of chairman, director, chief executive or other officer or employee of the banking company, pending consideration of other representation, it may order the concerned person from the date of the order.

a. shall not act as such chairman, director, chief executive or other officer or employee of the banking company.

b. Shall not in any way be concerned with or take part in the management of the banking company.

Any person agreed by the order of his removal, may appeal to the Central Government within 30 days from due date of communication. The decision of the Central Government shall be final and shall not be called into question.

In case an order is issued pursuant to above section, the concerned person shall cease to be a chairman, director, chief executive or other officer or employee of the banking company for a period not exceeding five years as

may be specified in the order. Contravention of the above provision shall be punishable with a fine, which may extend to Rs.250 for each day.

Where an order has been made under this section, the Reserve Bank of India may appoint any suitable person, in place of the person who has been removed, indicating the date from which he can act.

Any such order shall be valid for a period not exceeding three years or such further periods not exceeding three years at a time as the Reserve Bank of India may specify.

SECTION 36 AB: Power of reserve bank to appoint additional directors In the interest of Banking policy or in the public interest or in the interests of the banking company or in its depositors, the Reserve Bank of India may appoint additional directors for the banking company with effect from the date to be specified in the order.

Directors appointed under this section shall hold office for a period not exceeding three years or such periods not exceeding three years at a time as the Reserve Bank of India may specify.

SECTION 36 AE: Power of central government to acquire undertaking of banking companies in certain cases. This Section gives power to the Central Government of acquire the undertaking of a banking company. It provides that if on receipt of a report the Central Government is satisfied that a banking company

(i) has failed to comply with the directions given to it by the Reserve Bank of India relating to policy matters under section 21 and 35A or

(ii) is being managed in a manner detrimental to the interests of its depositors, and that

(iii) in the interests of the depositors of such banking company or

(iv) in the interests of banking policy or

(v) for the better provision of credit generally or of credit to any particular section of the community or in any particular area, it is necessary to acquire the undertaking of such banking company, the Central Government may, after such consultation with the Reserve Bank of India as it thinks fit, by notified order, acquire the undertaking of such company with effect from such date as may be specified in this behalf by the Central Government. In case of such a notification, on the specified date the undertaking of the acquired bank and its assets and liabilities shall stand transferred to, and vests in the Central Government.

Before acquiring the undertaking of any banking company, the Central Government shall give a reasonable opportunity to the banking company proposed to be acquired of showing cause against the proposed action.

SECTION 36 AF: Power of central government to make a scheme. The Central Government may after consultation with the Reserve Bank of India, make a scheme for carrying out the purposes of this part in relation to any acquired bank.

The scheme may provide for transfer of assets and liabilities of the acquired bank, constitution of the first Board of Management and incidental matters, the service conditions of the employees, compensation payable to the shareholders of the acquired bank and such other incidental, consequential and supplemental matters, as may be necessary to complete the transfer.

SECTION 36 AG: Compensation to be given to shareholders of the acquired bank. Compensation shall be paid to the registered shareholders of the acquired.bank in accordance with the principles provided in Schedule 5 of the Act. Any shareholder feeling the compensation to be inadequate may request the Central Government to refer the matter to the Tribunal to be constituted under Section 36 AH. If the number of representations received thus is not less than one fourth of the number of shareholders holding not less than one fourth of the paid-up share capital of the acquired bank, the Central Government shall constitute a Tribunal for the purpose

SECTION 36 AH: Constitution of the tribunal. The Tribunal shall consist of a Chairman and two other members.

Chairman shall be a person who is or has been a judge of the High Court or of the Supreme Court. Of the two other members, one shall be a person, who in the opinion of the Central Government has had Commercial Banking experience and the other shall be a person who is a Chartered Accountant.

SECTION 37: Suspension of business. The High Court may, on the application of a banking company which is temporarily unable to meet its obligation make an order (a copy of which it shall cause to be forwarded to the Reserve Bank of India) staying the commencement of continuance of all actions and proceeding against the company for some period. This temporary suspension of enforcement of liability against the banking company is called "moratorium". The period of Moratorium shall not exceed six months in all. The High Court shall not entertain such application unless it is accompanied by a report of the Reserve Bank of India indicating that in the opinion of the Reserve Bank of India the banking company will be able to pay its debts if the application is granted. The High Court shall call for a report from the Reserve Bank of India on the affairs of the banking company.

The High Court may, on receipt of the report either rescind any order already passed or pass such further order there on as may be just and proper in the circumstances. The High Court may also when an application is made to it, appoint a special officer who shall forthwith take into his custody or under his control all the assets, books, documents effects and actionable claims to which the banking company is appears to be entitled. He shall also exercise such other powers as the High Court confers on him having regard to the interest of the depositors of the banking company.

Where the Reserve Bank of India is satisfied that the affairs of a banking company in respect of which a moratorium order has been made, are being conducted in a manner detrimental to the interests of the depositors, it may make an application to the High Court to the winding up of the Company. In case any such application is made the High Court shall not make any order extending the period for which the commencement or continuance of all actions and proceeding against the company were stayed under the moratorium order.

SECTION 38: Winding up by high court. A High Court shall order the winding up of banking company.

a. if the banking company is unable to pay its debts or

b. if an application for its winding up has been made by Reserve Bank of India under Section 37 or this Section.

The Reserve Bank of India shall make an application for winding up of the banking company, if it is directed to do so under provisions of a Clause d of Sub-section 4 of Section 35.

The Reserve Bank of India may apply for winding up of a banking company under the following circumstances:

1. failure to comply with requirements of Section 11
2. disentitlement to carry on banking business by reason of the provisions of Section 22;
3. prohibition from receiving fresh deposits by an order made under Class a of Sub-Section 4 of Section 35 or under Clause b of Sub-section 3A of Section 42 of the Reserve Bank of India Act 1934.
4. failure to comply with requirements of this Act other than Section 11 of the Act and continuance of such failure or contravention of any provision and continuance of such failure or contravention of any provision and continuance of such contravention, beyond the period permitted by the Reserve Bank of India

Again, the Reserve Bank of India may prefer an application for winding up under the following situations;

i. a compromise or arrangement sanctioned by a Court in respect of the banking company cannot be worked satisfactorily with or without modifications; or

ii. the returns, statements of information furnished to it under or pursuance of the provisions of this Act disclose that the banking company is unable to pay its debts; or

iii. the continuance of the banking company is prejudicial to the interests of its depositors.

For the purpose of this section, a banking company shall be deemed to be unable to pay the debts, if it has refused to meet any lawful demand made at any of its offices or branches within two working days, if such demand is made at a place, where there is an office, branch or agency of the Reserve Bank of India or within five working days if such demand is made elsewhere and if the Reserve Bank of India certifies in writing that the banking company is unable to pay its debts.

SECTION 44 A: Procedure for amalgamation of banking companies. No banking company can amalgamate with another banking company unless a scheme containing the terms of such amalgamation has been placed in draft before the shareholders of each of the banking companies concerned separately, and approved by a resolution passed by a majority (in number representing two-thirds in value) of the shareholders of each of the said companies.

Notice of every such meeting shall be given to every shareholder of each of the banking companies concerned in accordance with the relevant Articles of Association, indicating the time, place and object of the meeting, and shall also be published at least a once a week for three consecutive weeks in not less than two newspapers which circulate in the locality or localities where the registered offices of the banking companies concerned are situated, one of such newspapers being in a language commonly understood in the locality or localities. Any shareholder, who has voted against the scheme of amalgamation at the meeting or had given notice in writing at prior to the meeting of the company concerned or to the presiding officer of the meeting that the dissents from the scheme of amalgamation, shall be entitled, in the event of the scheme being sanctioned by the Reserve Bank of India to claim from the banking company concerned, in respect of the shares held by him in that company; their value as determined by the Reserve Bank of India when sanctioning the scheme. Such determination by the Reserve Bank of India as to the value of the shares to be paid to the dissenting shareholder shall be final for all purposes.

If the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of this section, it shall be submitted to the Reserve Bank of India to sanction. If the scheme is sanctioned by the Reserve Bank of India by an order in writing it shall be binding on the banking companies concerned and also on all the shareholders there of. On sanctioning the scheme of amalgamation by the Reserve Bank of India, the assets and liabilities of the amalgamated banking company shall become those of the banking company which under the scheme of amalgamation is to acquire the business of the amalgamated company. The Reserve Bank of India may pass a further order by which the amalgamated company shall stand dissolved and shall transfer a copy of the order directing such dissolution registered. On receipt of such order the Registrar shall strike off the name of the company from the Register.

SECTION 44B: Restriction on compromise or arrangement between banking company and creditors. Notwithstanding anything contained in any law for the time being in force, no High Court shall sanction a compromise or arrangement between a banking company and its creditors or any class of them, or between such company and its members or any class of them, or sanction any modification in such compromise or arrangement unless the compromise, arrangement, modification in such compromise or arrangement unless the compromise, the arrangement, modification is certified by the Reserve Bank of India in writing as not being incapable of being worked and as not being detrimental to the interests of the depositors of such banking company.

Where an application in respect of a banking company is made under Section 391 of the Companies Act, the High Court may direct the Reserve Bank of India to make an enquiry in relation to the affairs of the banking company and the conduct of its directors and when such direction is given, the Reserve Bank of India shall make such enquiry and submit its report to the High Court.

SECTION 45: Power of the reserve bank to apply to central government for suspension of business by banking company and prepare scheme of reconstitution or amalgamation. This section was introduced by the Banking Companies Amended Act, 1960.

Where the Reserve Bank of India feels that there is good reason for applying to Central Government for order or moratorium in respect of a banking company, it may do so.

The total period of moratorium, make any payment to any depositors or discharge any liabilities or obligations to any other creditors.

The Reserve Bank of India, if it is satisfied that;

1. in the public interest or
2. in the interests of the depositors or

3. in order to secure the proper management of the banking company or
4. in the interest of the banking system of the country as a whole, if it is necessary o do so, may prepare a scheme – for the reconstruction of the banking company or
5. for the amalgamation of the banking company with any other banking institution.

This scheme may relate to the constitution, name, registered office, capital assets, powers, rights, interest, authorities and privileges, liabilities, duties and obligations, and as may be specified more elaborately in the scheme.

The scheme prepared by the Reserve Bank of India has to be transmitted to the banking company to be reconstructed or with which it will be amalgamated for suggestions and objections. The scheme thereafter will be placed before the Central Government for its modification and sanction. Once the Central Government sanctions the scheme, it becomes binding on the banking company and also on the shareholders and creditors of the company concerned.

SECTION 45Z: deals with return of paid instruments to customers as per which provisions the banking company can return the paid instruments to the customers after taking and keeping a true copy of such instrument, the cost of which shall be borne by the customer.

SECTION 53: Power to exempt in certain cases: This Section provides that on the recommendation of the Central Government, the RBI can grant exemption from the applicability of the provisions of the Sections in the ACT to any Banking Company or a group of Banking Companies for such period as it may consider necessary.

SECTION 56: in detail specifies the applicability of the Act to Co-operative Banks.

Check your progress

Fill in the blanks:

1. Banking Regulation Act applies to cooperative banks that have paid up capital and reserves exceeds___________.
2. Maximum period for holding non banking assets by a banking company is________years.
3. Minimum capital requirements applicable to nationalized banks as per section 11 of the Banking Regulations Act are___________.
4. As per provisions of section 17 of Banking Regulation Act, banking companies are to transfer not less than _____% of net profits to the reserve fund.

5. A Scheduled Bank has to keep cash reserve with only ________.
6. Maximum period of moratorium is ________.

Let us sum up

The Banking Companies Act came into force in Feb. 1949 the name of the Act was changed in 1966. In 1949 the Banking Regulation Act was passed which is the controlling tower of the Indian banking system. The salient provisions of this act have been widely discussed in this chapter.

Glossary

The Banking Regulation Act : An enactment legislated primarily to protect the interest of the depositors and regulate the conduct of banking I the country.

Reserve Fund : Reserve created out of the profit of the banking companies and kept as a reserve fund as per section 17 of the Banking Regulation Act.

Cooperative Banks : Banks established under different cooperative enactment.

Answers to check your progress

1. Rs. 1 Lakh
2. Seven years
3. Not applicable
4. 20%
5. Only RBI
6. Six months

Model Questions

1. Trace the evolution of the Banking Regulation Act, 1949.
2. When can the Reserve Bank of India conduct inspection?
3. When can a Banking company wound up?
4. Write five provisions of the Banking Regulations Act, 1949.

BLOCK III

BANKER AND CUSTOMER

Unit - 8 : Banker and Customer

Unit - 9 : Types of Deposits

Unit - 10 : Special types of Customers

Unit 8

BANKER AND CUSTOMER

STRUCTURE

Overview

Learning Objectives

8.1 Definitions of the banker

8.2 Definition of a Customer

8.3 Businesses Permitted for a Banking Company

8.4 Services Rendered by Banks

8.5 Relationship between a Banker and a Customer

8.6 Obligations of a Banker

8.7 Rights of a Banker

- *8.7.1 Right of general lien*
- *8.7.2 Right of Set-off*
- *8.7.3 Banker's right of Appropriation*
- *8.7.4 Right to interest and incidental charges*

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

The banker and customer relations are governed by a contract between them. Certain obligations and rights of a banker arise out of the relationship between the banker and his customer.

LEARNING OBJECTIVES

Before understanding the relationship between the banker and the customer, the definitions of the terms "banker and customer" is dealt with in this unit. The relationship between them depends upon the nature of services provided by a banker. In this unit, the following facts permissible for bankers as per the Banking Regulation Act are highlighted: Relationship between the banker and the customer, Obligation of a banker and the rights of a banker.

8.1 DEFINITIONS OF THE BANKER

The term 'banker' is defined in Section 3 of the Negotiable Instruments Act, which reads as under: "Banker includes any person acting as a banker and any post office saving bank". In other words, a banker means any person who acts a banker, and it also includes a post office saving bank. It may be

noted that this section does not clearly define the term banker. It simply states who is included in the term 'banker'. As a matter of fact, there is no statutory definition of the term 'banker' in any Act. However, Sections 5 (b) and 5 (c) of the Banking Regulation Act, 1949, which respectively define the terms 'banking' and 'banking company', help us in knowing who is a banker. These sections respectively read as under:

"Banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise" "Banking company means any company which transacts the business of banking in India."

The analysis of these two provisions reveals that a banker is one who accepts money from the public for the purpose of landing or investment, and repays the same by cheque or otherwise. The accepted definition of the term "banker" is given by Dr. Herbert L.Hart, the author of the well-known treatise, Law of Banking in the following words: 'A banker is one, who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current accounts". The definition given by Dr. Hart is further supported by Sir John Paget, another great author who states that "no person or body corporate or otherwise can be a banker who does not (1) take deposit accounts. (2) take current accounts, (3) issue and pay cheques, and (4) collect cheques crossed and uncrossed for his customers"" It may, however, be noted that every person who receives the money of another, and pays it according to his orders cannot be regarded as a banker, unless he establishes that business for profit. Sir John Paget has also stressed that a banker's main business must be that of banking from which, generally, he should be able to earn his living.

8.2 DEFINITION OF A CUSTOMER

There is no statutory definition of the term 'customer' also. But it is defined in judicial decisions which are commonly accepted in England as well as in India. A customer means a person who keeps an account with a banker. It may be a current account or a deposit account. It is, however, not necessary that the account should be of long standing. So far as the banking dealings are concerned, the term 'customers' signifies a relationship in which duration is not material. Thus, a customer is a person whose money has been accepted by the banker on the footing that the banker will honour cheques up to the amount standing to his credit irrespective of the fact whether his connection is of short or long standing. Dr.Hart, an author of Law of Banking defines the term customer in the following words:

"A customer is one who has an account with a banker or for whom a banker habitually undertakes to act as such". Thus, a person is a customer who has

some sort of bank account in his name and for whom the banker undertakes to provide the facilities as a banker. It may, however, be noted that mere casual acts of service do not create the relationship of banker and customer. The dealing must be of a banking nature. Thus, if a person occasionally goes to the bank to buy a draft or to get the cheque encashed without opening the account or to deposit valuables in a locker, he does not become a customer of the banker because such transactions are not regarded in the nature of real banking business.

8.3 BUSINESSES PERMITTED FOR A BANKING COMPANY

The Banking Regulation Act specifies other of businesses a banking company may be engaged in. According to section 6, the following business may be undertaken by a banking company:

Main Functions Are:

- ★ the borrowing, raising or taking of money;
- ★ the lending or advancing of money either upon security or without security
- ★ the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scripts and other instruments and securities whether transferable or negotiable or not;
- ★ the granting and issuing of letters of credit, travellers' cheques and circular notes;
- ★ the buying, selling and dealing in bullion and specie;
- ★ the buying and selling offoreign exchange including foreign bank notes;
- ★ the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds;
- ★ the purchasing and selling of bonds, scrips and other forms of securities on behalf of constituents or others;
- ★ the negotiating of loans and advances;
- ★ the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise;
- ★ the providing of safe deposit vaults; and
- ★ the collecting and transmitting of money and securities.

Other Functions:

(a) It may act as an agent of the Government, local authority or person and can carry on agency business but it cannot act as secretary and treasurer of a company.

(b) It may contract for public and private loans and negotiate and issue the same.

(c) It may effect, insure, guarantee, underwrite, participate in managing and carrying out of any issue of State, municipal or other loans or of shares, stock, debenture stock of companies and may be lend money for the purpose of any issue.

(d) It may carry on and transact every kind of guarantee and indemnity business.

(e) It may mange, sell and realize any property which comes into its possession in satisfaction of its claims.

(f) It may acquire and hold and deal with any property or any right, title or interest in any property which may form the security for any loan or advance.

(g) It may undertake and execute trusts.

(h) It may undertake the administration of estates as executor, trustee or otherwise.

(i) It may establish, support and aid, associations, institutions, funds, trusts, etc., for the benefit of its present or past employees and may grant money for charitable purposes.

(j) It may acquire, construct and maintain any building for its own purposes.

(k) It may sell, improve, manage, develop, exchange, lease, mortgage, and dispose of all or any part of the property and rights of the economy.

(l) It may acquire and undertake the whole or any part of the business of any person or company, when such business is of a nature described in Section 6 (1).

(m) It may do all such things which are incidental or conducive to the promotion or advancement of the business of the company.

(n) It may undertake any other form of business which the Central Government may specify as a form of business in which it is lawful for a banking company to engage.

8.4 SERVICES RENDERED BY BANKS

The range of services offered differs form bank to bank, depending mainly on the size and type of the banks, but the acceptance of deposits from the public and provision of credit form the mainstay of the banking business. The services

offered by the commercial banks may be classified into (1) services to depositors and borrowers for providing credit to them, and (2) ancillary services.

Services Rendered to Depositors and Borrowers:

Banks open various types of deposit accounts and render the following services to the depositors and borrowers:

1) Collection of cheques, demand drafts, bills of exchange, promissory notes, hundies and foreign documentary and clean bills.
2) Purchase of local and foreign currency documentary/clean bills, negotiation of bills under inland and foreign letters of credit, advising of inland and foreign letters of credit established by branches and correspondents.
3) Carrying out the standing instructions for the payment of insurance premia, subscriptions, certain taxes and gift remittances.

Ancillary Services

1. Performance Guarantee and Financial Guarantees.
2. Safe Custody of Deeds, Securities.
3. Safe Deposit Vault.
4. Purchase and Sale of Securities.
5. Collection of Interest on Securities/Debentures and Dividend on Shares, Collection of Pension Bills.
6. Remittance of Funds-Bank Drafts, Mail Transfers, elegraphic Transfers.
7. Executor and Trustees.
8. Personal TaxAssistance, preparing Income Tax, Sales Tax and Wealth Tax returns.
9. Investment Facilities-Underwriting, Banker to new issues, Guidance to investment, Stock Exchange assistance.
10. Credit Transfers.
11. Credit Cards.
12. Travelers Cheques and Gift Cheques.
13. Emergency Vouchers.
14. Sale of Units of Unit Trust of India

8.5 RELATIONSHIP BETWEEN A BANKER AND A CUSTOMER

Relationship as Debtor and Creditor:

The legal relationship between a banker and his customer is based on the contract between them. Primarily, their relationship is that of a debtor and

creditor. When a customer deposits money with a banker, the banker becomes the debtor and the customer becomes the creditor. And when the banker lends money to his customer, the banker becomes the creditor and the customer, the debtor. It will be interesting to know that the money deposited with the banker is at his disposal and he can deal with it as he wants., The banker is, however, under an obligation to honour the cheques of his customer i.e. the banker is under obligation to repay the money when the customer demands payment. This relationship differs from similar relationship arising out of ordinary debts in following respects:

The Creditor must Demand Payment: In case of ordinary commercial debt, the debtor pays the amount on the specified date or earlier or whenever demanded by the creditor as per the terms of the contract. But in case of a deposit in the bank, the debtor/banker is not required to repay the amount on his accord. It is essential that the depositor (creditor) must make a demand for the payment of the deposit in the proper manner. This difference is due to the fact that a banker is not an ordinary debtor; he accepts the deposits with an additional obligation to honour his customer's cheques.

Proper Place and Time of Demand: The demand by the creditor must be made at the proper place and in proper time. A commercial bank, having a number of branches, is considered to be one entity, but the depositor enters into relationship with only that branch where an account is opened in his name. It is also essential that the demand must be made during banking hours only on a working day of the bank.

Demand must be made in Proper Manner: According to the statutory definition of banking, deposits are withdrawable by cheque, draft, order or otherwise. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the bankers.

Banker as Trustee

Ordinarily, a banker is a debtor of his customer in respect of the deposits made by the latter, but in certain circumstances he acts as a trustee also. A trustee holds money or assets and performs certain functions for the benefit of some other person called the beneficiary. For example, if the customer deposits securities or other valuables with the banker for safe custody, the latter acts as a trustee of his customer. The customer continues to be the owner of the valuables deposited with the banker. The legal position of the banker as a trustee, therefore, differs from that of a debtor of his customer. In the former case the money or documents held by him are not treated as his own and are not available for distribution amongst his general creditors in case of liquidation. The relationship between the banker and his customer as

a trustee and beneficiary depends upon the specific instructions given by the latter to the former regarding the purpose of use of the money or documents entrusted to the banker.

Banker as Agent

A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. For example, he buys or sells securities on behalf of his customer, collects cheques on his behalf and makes payment of various dues of his customers, e.g., insurance premium, etc. The range of such agency functions has become much wider and the banks are now rendering large number of agency services of diverse nature. For example, some banks have established Tax Service Departments to take up the tax problems of their customers.

8.6 OBLIGATIONS OF A BANKER

The obligations of a banker arising out of his relationship with the customer may be discussed under the following heads:

Obligation to honour cheques of his customer: The banker is under statutory obligations to honour the cheques of his customer. This provision is contained in Section 31 of the Negotiable Instruments Act, which reads as under:

"The drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheques, must pay the cheque when duly required so to do, and in default of such payment, must compensate the drawer for any loss or damage caused by such default".

In other words, the banker is legally bound to honour the cheques of his customer so long as there are sufficient funds to the credit of his customer properly applicable to the payment of the cheque. If the banker wrongfully refuses to honour these cheques, he is liable to the customer for damages. The damages which the customer can recover for unjustified dishonour of cheque is not limited to actual pecuniary loss, but also extends to loss of credit or injury to his reputation. Thus, the customer can recover very substantial damages. It may, however, be noted that the banker is liable to the customer (drawer of a cheque) only. The payee or the holder of a cheque has no cause of action against the banker as there is no privity of contract between the banker and the payee or the holder. In certain circumstances, the banker is justified in refusing the payment of a cheque. In such cases, he is not liable for damage.

Garnishee Order: The obligation of a banker to honour his customer's cheques is extinguished on receipt of an order of the Court, known as the Garnishee order, issued under Order 21, Rule 46 of the Code of Civil

Procedure, 1908. If a debtor fails to pay the debt owed by him to his creditor, the latter may apply to the Court for the issue of a Garnishee Order on the Banker of his Debtor. Such order attaches the debts not secured by a negotiable instrument, by prohibiting the creditor from recovering the debt and the debtor from making payment thereof. The account of the customer with the banker, thus, becomes suspended and the banker is under an obligation not to make any payment thereof. The account of the customer with the banker, thus, becomes suspended and the banker is under an obligation not to make any payment from the account concerned after the receipt of the Garnishee Order. The Creditor at whose request the order is issued is called the judgment-creditor; the debtor whose money is frozen is called judgment-debtor and the banker who is the debtor of the judgment is called the Garnishee. The Garnishee Order is issued in two parts. First, the Court directs the banker to stop payment out of the account of the judgment-debtor. Such order, called **Order Nisi,** also seeks explanation from the banker as to why the funds in the said account should not be utilized for meeting the judgment-creditor's claim. The banker is prohibited from paying the amount due to his customer on the date of receipt of the Order Nisi. He should, therefore, immediately inform the customer so that dishonour of any cheque issued by him may be avoided. After the banker files his explanation, if any, the Court may issue the final order, called **Order Absolute** whereby the entire balance in the account or a specified amount is attached to be handed over to the judgment-creditor. On receipt of such an order the banker is bound to pay the garnished funds to the judgment-creditor. Thereafter the banker's liability towards his customer is discharged to that extent. The suspended account may be revived after payment has been to the judgment-creditor as per the directions of the Court. The following points are to be noted in this connection:

A garnishee order may attach either the entire amount of the judgment-debtor with the banker irrespective amount only which is sufficient to meet the creditor's claim from the judgment debtor.

The order of the Court restrains the banker from paying the debts due or accruing due. The words 'accruing due' mean the debts which are not payable but for the payment of which an obligation exists. If the account is overdrawn, the banker owes no money to the customer and hence the Court Order ceases to be effective. A bank is not a garnishee with respect to the unutilized portion of the overdraft or cash credit facility sanctioned to its customer and such unutilized portion of cash credit or overdraft facility cannot be said to be an amount due from the bank to its customer.

The Garnishee Order attaches the balance standing to the credit of the principal debtor at the time the order is served on the banker. The following points are to be noted in this connection:

The Garnishee Order does not apply to (1) the amounts of cheques, drafts, bills, etc., sent for collection by the customer, which remain uncleared at the time of the receipt of the order, (2) the sale proceeds of the customer's securities, e.g., stocks and shares in the process of sale, which have not been received by the banker.

The Garnishee Order cannot attach the amounts deposited into the customer's account after the Garnishee Order has been served on the banker. A Garnishee Order applies to the current balance at the time the order is served, it has no prospective operation.

The Garnishee Order is not effective on the payments already made by the banker before the order is served upon him. But if a cheque is presented to the banker for payment and its actual payment has not yet been made by the banker and in the meanwhile a Garnishee Order is served upon him, the latter must stop payment of the said cheque, even if it is passed for payment. Similarly, if a customer asks the banker to transfer an amount from his account and the banker has already made necessary entries of such transfer in his books, but before an intimation could be sent to the other account holder, a Garnishee Order is received by the banker, it shall be applicable to the amount so transferred by mere book entries, because such transfer has no effect without proper communication to the person concerned.

In case of cheques presented to the paying banker through the clearing house, the effectiveness of the Garnishee Order depends upon the fact whether the time for returning the dishonoured cheques to the collecting banker have expired or not. Every drawee bank is given specified time within which it has to return the unpaid cheques, if any, to the collecting bank. If such time has not expired and in the meanwhile the bank receives a Garnishee Order, it may return the cheque dishonoured. But if the order is received after such time is over, the payment is deemed to have been made by the paying banker and the order shall not be applicable to such amount.

The Garnishee Order is not applicable to: (i) Money held abroad by the judgment-debtor; and

ii. Securities held in the safe custody of the banker.

a. The Garnishee Order may be served on the Head Office of the bank concerned and it will be treated as sufficient notice to all of its branches. However, the Head Office is given reasonable time to intimate all concerned branches. If the branch office makes payment out of the customer's account before the receipt of such information, the banker will not be held responsible for such payment.

Application of the Garnishee Order to Various Types of Account

a) Joint Accounts

A joint account is opened in the names of two or more persons. If only one of them is a judgment-debtor, the joint account cannot be attached. But if both or all the joint account-holders are joint judgment-debtors in any legal proceedings, the joint account can be attached. For example, if **A** owes a debt of Rs. 1,000/- to **B** in his personal capacity, the latter cannot pray for the attachment of a joint account in the names of **A** and **C.** But if **A** and **C** are jointly responsible for the debt, their joint account may be attached.

But the reverse is possible, i.e., in the case of a debt jointly taken by two or more joint judgment-holders, their individual accounts with the banks may be attached because each one of them is jointly and severally liable for the loans jointly taken by them.

b) Partnership Account

In case of a debt taken by a partnership, firm, the personal accounts of the partners can also be attached in addition to the account in the name of the firm because the liability of the partners is both joint and several. But the reverse is not possible. If a partner is a judgment-debtor, only his individual account may be attached and not that of the firm or those of other partners.

c) Trust Accounts

A trustee holds the funds or property of some one else for the benefit of the beneficiary. An account opened in the personal name of the Trustee, in his capacity as such, cannot be utilized for paying his personal liabilities. The banker should, therefore, inform the court that the account is a Trust account and in the meanwhile stop payments from the accountand instruct the Trustee.

Obligation not to disclose information concerning his customer's account or affair: As a matter of fact, the relationship between the banker and his customer is confidential. And thus, the banker should not disclose the information concerning the account and affair of his customer. This is to protect the credit and reputation of the customer. If the banker fails in this duty, he may be held liable for damages for loss of credit or reputation.

Obligation to maintain proper and accurate account: The banker is also under obligation to maintain proper and accurate account of all credits and debits of his customer. If the banker makes some wrong credit in his customer's account and relying upon the accuracy of the entry, the customer acts in good faith and alters his position to his prejudice, then the banker may not recover the amount from the customer which was wrongly credited to his customer's account. The customer's position is altered to his prejudice when on the basis of the amount to his credit; he issues cheques which are duly paid by the banker. It may, however, be noted here that the customer should

also act in good faith and without negligence. Moreover, if the banker wishes to close the account of his customer, he must give a reasonable notice to his customer. This enables the customer to make other arrangements, and the customer may not issue any more cheques

Obligation to abide by the directions given by the customer: We know that the relationship of banker and customer is governed by terms of the contract between them. Thus, the banker must abide by the specific and clear instructions which are expressly given by the customer. However, the banker is under obligation to abide by the instructions only if they are within the scope of their relationship.

Obligation to collect cheques and drafts on behalf of the customer: A banker is also under obligation to collect the cheques and drafts on behalf of his customer. In such a case, the banker needs special protection because it is difficult to verify the title of each and every holder of a cheque.

8.7 RIGHTS OF A BANKER

The obligation of a banker arises out of legal relationship between a banker and his customer. The banker also has certain rights against his customer which may be discussed under the following heads:

8.7.1 Right of general lien

This right of banker is contained in Section 171 of The Indian Contract Act, which reads as under:

"Bankers may, in the absence of a contract to the contrary, retain as a security for a general balance of account, any goods bailed to him."

In other words, a banker can exercise his right of lien on all goods and securities deposited with the banker. It is, however, necessary that the goods should have been given to the banker only as a bailee because the lien extends only to the goods which have been bailed to the banker.

Special Features of a Banker's Right of General Lien

i) The banker possesses the right of general lien on all the goods and securities entrusted to him in his capacity as a banker and in the absence of a contract inconsistent with the right of lien. Thus the cannot exercise his right of general lien if:

a. the goods and securities have been entrusted to the banker as a trustee or an agent of the customer; and

b. a contract-express or implied-exists between the customer and the banker which is inconsistent with the banker's right of general lien.

ii) A Banker's Lien is Tantamount to an Implied Pledge. As noted above the right of lien does not confer on the creditor the right of sale but only the right to retain the goods till the loan is repaid.

iii) The Right of Lien is conferred upon the Banker by the Indian Contract Act. No separate agreement or contract is, therefore, necessary for this purpose.

iv) The right of Lien can be exercised on goods or other securities standing in the name of the Borrower only and not jointly with others.

v) The Banker can Exercise his right of lien on the Securities Remaining in his Possession after the loan, for which they were lodged, is repaid by the customer, if no contract to contrary exists.

Exceptions to the Right of General Lien:

The right of lien cannot be exercised in the following circumstances:

a. Safe custody Deposits: When a customer deposits his valuables-securities, documents, ornaments, etc.-with the banker for safe custody, he entrusts them to the banker as a bailee or trustee with the purpose to ensure their safety from theft, fire, etc. A contract inconsistent with the right of lien, therefore, exists. The banker cannot exercise his right of general lien over such valuables.

b. Documents Deposited for Special Purpose. If a customer sends a bill of exchange or any other document with he specific instruction to utilize its proceeds for any specific purpose, a contract inconsistent with the right of lien is presumed to exist.

c. Right of General Lien becomes that of Particular Lien. Banker's right of general lien is displaced by circumstances which show an implied agreement inconsistent with the right of general lien

d. Securities left with the banker negligently. The banker does not possess the right of lien on the documents or valuables left in his possession by the customer by mistake or by negligence.

e. The banker cannot exercise his right of lien over the securities lodged with him for securing a loan, before such loan is actually granted to him.

f. Securities held in Trust: The banker cannot exercise his right of general lien over the securities deposited by the customer as a trustee in respect of his personal loan. But if the banker is unaware of the fact that the negotiable securities do not belong to the customer, his right of general lien is not affected.

g. Banker possesses right of set-off and not lien on money deposited. The banker's right of lien extends over goods and securities handed over to the banker. Money deposited. In the bank and the credit balance in the accounts do not fall in the category of goods and securities. The banker may, therefore, exercise his right of set-off rather the right of lien in respect of the money deposited with him.

8.7.2 Right of Set-off

The right of set-off can be exercised subject to the fulfillment of the following conditions:

The Accounts Must be in the Same Name and in the Same Right: The first and the most important condition for the application of the right of set-off is that the accounts with the banker must not only be in the same name but also in the same right. By the words 'the same right' is meant that the capacity of the account-holder in both or all the accounts must be the same, i.e., the funds available in one account are held by him in the same right or capacity in which a debit balance stands in another account. The underlying principle involved in this rule is that funds belonging to someone else, but standing in the name of the account-holder, should not be made available to satisfy his personal debts. The Funds Held in Trust Accounts are Deemed to be in Different Rights. If a customer opens a separate account with definite instructions as regards the purpose of such account, the latter should not be deemed to be in the same right. In case of a joint account, a debt due from one of the joint account-holders in his individual capacity cannot be set off against an amount due to him by the bank in the joint account. But the position may appear to be different if the joint account is payable to 'former or survivor'. Such an account is deemed to be primarily payable to the former and only after his death to the survivor. Thus the farmer's debt can be set off against the balance in the joint account.

The Right Can be exercised in Respect of Debts Due: and not in respect of future debts or contingent debts. The Amount of Debts must be certain. It is essential that the amount of debts due from both the parties to each other must be certain.

The Right may be exercised in the absence of an agreement to the contrary: If there is an agreement-express or implied-inconsistent with the right of set-off, the banker cannot exercise such right.

8.7.3 Banker's Right of Appropriation (Rule in Clayton's Case)

In the case of his usually business, a banker receives payments from his customer. If the latter has more than one account or has taken more than one account or taken more than one loan from the banker, the question of appropriatio ı of the money subsequently deposited by him naturally arises. Sections 59 to 61 of the Indian Contract Act, 1872 contain provisions regarding the right of appropriation of payments in such cases. According to Section 59 such right of appropriation is vested in the debtor, who makes the payment to his creditor to whom he owes several debts. He can appropriate the payment by (i) an express intimation or (ii) under circumstances implying that the

payment is to be applied to the discharge of some particular debt. If the creditor accepts such payment, it must be applied accordingly.

If the debtor does not intimate or there is no other circumstances indicating to which debt the payment are to be applied, the right of appropriation is vested in the creditor. He may apply it at his discretion to any lawful debt actually due and payable to him from the debtor (Section 60). Further, where neither party makes any appropriation, the payment shall be applied in discharge of the debts in order of time. If the debts are of equal standing, the payment shall be applied in discharge of each proportionately (Section 61).

In case a customer his a single account and he deposits and withdraws money from it frequently, the order in which the credit entry will set off the debit entry is the chronological order, as decided in the famous Clayton's Case, discussed below.

Clayton's Case (Devaynes v. Noble (1816) I. Mer. 529, 572)

A firm of bankers known as Devaynes, Daives, Noble & Co. had five partners. Devaynes, the senior partner, died and the surviving partners carried on the business of banking under the same name. The executors of the deceased partner objected to the continuance of the name of Devaynes in the firm's name. After a year the firm became bankrupt and various classes of creditors of the firm placed their claims against the estate of Devaynes, the deceased partner.

N.Clayton was one of those creditors who continued to deal with surviving partners by making payments to and receiving payments from the firm. At the time of death of Devaynes, Clayton's balance was 1713 Pounds. During the next few days he withdrew several times and thus the balance was reduced to 453 Pounds. Thereafter surviving partners paid more than 1713 Pounds to him and subsequently his deposits with the firm largely exceeded the amounts withdrawn by him and thus his credit balance at the time of bankruptcy of the firm was larger than the amount which was due to him at the time of death of Devaynes.

Clayton claimed that the amount of 453 Pounds (as reduced by the dividend on this amount which he received from the Liquidator of the firm) was due to him from the estate of the deceased partner. His contention was that:

a. the withdrawals from the account after the death of the partner were paid out of the deposits made in the same period and thus

b. the credit balance standing in at the time of the partner's death was recoverable from the deceased partner's assets.

These arguments were not accepted by the Court and Clayton's claim was rejected. Sir William Grant M.R. observed the general rule of appropriation as follows:

"This is the case of a banking account where all the sums paid in form one blended fund, the parts of which have no longer any distinct existence...... In such a case there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place and are carried into the account. Presumably, it is the sum first paid in, that is first drawn out. It is first item on the debit side of the account that is discharged or reduced, by the first item on the credit side."

Thus the first item on the debit side will be the item to be discharged or reduced by a subsequent item on the credit side. The credit entries in the account adjust or set off the debit entries in the chronological order.

The rule derived from the Clayton's case is of great practical significance to the bankers. In case of death, retirement or insolvency of a partner of affirm, the then existing debt due from the firm is adjusted or set off by subsequent credit made in the account. The banker thus losses his right to claim such debt from the assets of the deceased, retired or insolvent partner and may ultimately suffer the loss if the debt cannot be recovered from the remaining partners. Therefore, to avoid the operation of the rule given in the Clayton's case the banker closes the old account of the firm and opens a new one in the name of the reconstituted firm. Thus the liability of the deceased, retired or insolvent partner, as the case may be, at the time of his death, retirement or insolvency is determined and he may be held liable for the same. Subsequent, deposits made by surviving solvent partners will not be applicable to discharge the same.

8.7.4 Right to interest and incidental charges

The banker is entitled to charge interest on the money lent to his customer, and also to claim incidental charges e.g. commission for collection etc. However, the banker can claim the interest and incidental charges as per the rules communicated to the customer.

Check your progress

Fill in the blanks:

1. Accepting for the purpose of lending or investing is known as_______________.
2. A person who has an account in a bank is called _______________.
3. The relationship between the banker and customer as a trustee and beneficiary depends upon _______________, regarding the purpose of use of money or documents entrusted to the banker.
4. The banker is prohibited from paying the amount due to the customer on the date of receipt of the _______________.

Let us sum up

The banking company is defined as a company, transacting banking business. It should perform both the essential functions – accepting deposits and lending or investing. Banking functions are borrowing, lending, issuing letters of credit, providing safety vaults, acting as an agent to the Govt. and so on. It also collects cheques on behalf of the customer, makes credit transfers and issues credit cards.

The relationship between the banker and a customer is that of a debtor and creditor. Sometimes, the banker also acts as a trustee, in respect of deposits made by the customer. The banker performs a number of agency functions for the convenience of the customer.

The banker has a obligation to honour the cheques of his customer. This obligation is extinguished on receipt of a Garnishee Order. He also has an obligation to maintain the secrecy of the customer's account.

One of the important right enjoyed by the banker is a right of general lien. Lien means the right of the creditor to retain the goods and securities owned by the debtor until the debt due from him is repaid.

Banker has a right to set off, enabling him to combine two accounts in the name of the same customer and to adjust the credit balance of one account with the debit balance of another account. The banker has a right of appropriation in a chronological order as decided in Claytons rule. The banker has an implied right to charge interest, incidental charges, etc. on the advances granted to the customer.

Glossary

Banking : It is defined as accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand.

Customer : A customer is one, who has an account with a banker or for whom a banker habitually undertakes to act as such.

Garnishee Order : The obligation of a banker to honour his customer's cheques is extinguished from receipt of a court order is known as a Garnishee Order.

Answers to check your progress

1. banking 2. a customer 3. the specific instruction 4. Order Nisi

Model Questions

1. Define a banker and a customer.
2. What are the general and special relationship between the banker and the customer?
3. State the rule of Clayton's case regarding appropriation of payments.
4. What is a Garnishee Order? Explain the provisions relating to it.

Unit 9

TYPES OF DEPOSITS

STRUCTURE

Overview

Learning Objectives

9.1 Regulation of competition in Banking

9.2 Types of Deposit accounts

9.3 Opening of a new Account

9.4 Bank Pass Book

9.5 Closing of a Bank A/c

9.6 Insurance of Bank deposit

9.7 Attractive savings schemes

9.8 Deposit schemes for Indian abroad

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

The relationship between a banker and his customer begins with the opening of an account by the former in the name of the latter. The bulk of the resources of a bank are mobilized by accepting deposits from the public. Accepting of deposits of money from the public is one of the essential functions of a banker according to the definition of banking given in Banking Regulations Act, 1949.

The banker solicits deposits from the members of the public belonging to different walks of life, engaged in numerous economic activities and having different facilities.

LEARNING OBJECTIVES

The bank accounts customarily are classified into three categories.

i. Savings deposits accounts

ii. The fixed deposit accounts, and

iii. The current accounts

In recent years a few new types of accounts have also been introduced by banks. The present unit discusses banker's practices in relation to the opening and operation of different types of customer's accounts.

9.1 REGULATION OF COMPETITION IN BANKING

Competition in the business of accepting deposits takes two forms: (i) improvement in the customer services; and (ii) offer of higher rates of interest to the depositors. Such competition, though essential for the growth of industry, is undesirable. Bankers realised the urgency of regulating competition amongst themselves in the field of deposit mobilisation as early as 1958 when the leading banks in the country entered into a voluntary agreement. The Inter-Bank Agreement on Deposit Rates prescribed the maximum rates of interest payable by member-banks. Modifications in such rates were made as and when felt necessary. After the nationalisation of 14 major commercial banks in July 1969, the Reserve Bank of India exercised its right to issue directive to the banks in regard to the deposit rates. The Inter-Bank Agreement was, therefore, withdrawn with effect from 1st April, 1970. The rates of interest on various types of deposits accounts and other terms, etc., were thereafter prescribed by the Reserve Bank through its directives issued from time to time. A notable feature of the Reserve Bank directive was that the freedom to compete in the banking business was controlled and regulated rather than completely abolished. The smaller banks with comparatively less deposits were enabling to compete with the bigger banks by offering the same rates of interest. In the directives of the Reserve Bank, therefore, smaller banks were permitted to compete with the bigger ones by offering reasonably higher rates of interest. Thus both the maximum and minimum rates of interest payable on deposits were prescribed for smaller banks. These banks were at liberty to determine their own rates within the limits prescribed by the Reserve Bank according to their own judgement and discretion.

During recent past the Reserve Bank has de-regulated the interest rates on deposits. Banks are now permitted to compete for deposits by prescribing their own rates of interest.

9.2 TYPES OF DEPOSIT ACCOUNTS

Fixed deposits: The legal position of the banker in connection with fixed deposit is one of a debtor. The banker continues to be a debtor, event though the period fixed for the deposit has expired and the deposit is not withdrawn and although the banker may not allow interest after the deposit has matured for payment, he does not become a trustee for the customer of the funds so lying with him.

In order to oblige their customers, bankers occasionally allow them to withdraw their fixed deposits before their due dates. In such cases, either the customer has to lose 2% interest on the interest rate kept for the period, as per the Reserve Bank directives when he borrows the amount required against the security of his fixed deposit at a rate of interest which is generally two to two

and half per cent higher than the rate allowed on the deposit. When doing so the banker requires the customer to discharge the Deposit receipt. In the latter case, the banker's advance is fully secured, as there can hardly be any security better than the amount due from the banker to the customer. By permitting the withdrawal of fixed deposits before their maturity, the banker impairs his own cash resources and thereby runs certain risks in case of the tightness of the money-market.

If a depositor does not take repayment on the date of maturity, the interest ceases to run from that date. The banks allow interest as per the Reserve Bank directive for the overdue period, provided the deposit is renewed for a further period.

When depositing his money, the customer receives a deposit receipt which is usually marked "not negotiable". It can, of course, be transferred by way of assignment to a third party, but a deposit receipt, not being a "negotiable instrument", cannot pass to its transferee a better title than that of the transferor, and, therefore, such receipts cannot be treated like cheques It could not be transferred by a mere endorsement in blank.

Section 130 of the Transfer of Property Act only requires that the document transferring or assigning the deposit becomes effective as soon as the document or instrument in writing is signed by the depositor.

In the absence of an agreement, valid cheques cannot be drawn against a deposit account at all, if that is the only account of the customer with the bank. Even after expiry of the fixed period the depositor is not entitled to draw cheques against the fixed deposit, unless he has either made such arrangements with the banker or has given instructions to him to transfer the amount to his current account.

As per Section 269T of the Income-tax Act, 1961 repayment of deposits together with interest aggregating Rs.10,000/- or more should be paid by an account payee cheque or account payee bank draft. With effect from 1st April, 1989 the limit has been raised to Rs.20,000. The obligation of a bank to pay the cheques of a customer rests 'primarily' on the branch at which he keeps his account and the bank can rightly refuse to issue a cheque at any other branch.

Whether the return of the deposit receipt to the banker is a condition precedent for the repayment of the deposit depends to a great extent upon the terms and conditions of the deposit. In practice the bankers obtain an indemnity bond before issuing a duplicate receipt.

Whether a particular deposit account is attachable by a garnishee order nisi, depends on the terms of the order. To be affected by the order, it must be a debt, "due, or, accruing due", at a definite and certain date. A balance standing

at the credit of a joint account though payable to either of them cannot be attached by a Garnishee Order.

The following kinds of deposits are attachable:

a) a deposit repayable are attachable
b) a deposit repayable on the expiry of fixed notice, which has been given;
c) a deposit repayable at a fixed future date, or after the lapse of a specified time.

Stop order by Police: Police can seize (attach) moneys in bank but the police have no power to prohibit a bank from paying a customer a sum out of his account on the ground that it is stolen money. Where a motor vehicle hypothecated to a bank is seized by the police as the vehicle was used in the commission of murder the Magistrate is justified in refusing to give a direction to release it to the bank the vehicle having been registered in the name of the accused.

Sub-section 3 of Section 226 of the Income-tax Act, 1961 empowers the Assessing Officer or Tax Recovery Office to require any person "from whom money is due or may become due to an assessee or any person who holds or may subsequently hold money for or on account of the assessee" to pay to the Office so much of the money as is sufficient to pay the income-tax due by the assessee.

A Banker's deposit receipt is exempt from stamp duty, provided the deposit is not expressed to be received from, or by the hands of, any person other than the one to whom the same is to be accounted for (the Indian Stamp Act, 1899, Schedule I, Article 53). The exemption holds good though a time is fixed for its repayment. It does the provision for the payment of interest.

Banks have now accepted the view that in an account where the operation is by "either or survivor", the survivor is the only person who is entitled to the balance thereof after the death of one of the account holders. This practice is based on the principle that the terms of operation form part of the contract of deposit.

Some banks open accounts with instructions to pay to "Former or Survivor". If such an account is in the names of A and B, the operation is by A, the first named party, so long as he is alive and after his death, by B; he is not entitled to operate during the life-time of A; he can operate only on and after A's death; If B dies first, the account can be operated solely by A and the legal representatives of B will have no right to the operation. The principle underlying the operation of these accounts is that instructions for operation constitute one of the terms of the contract of deposit. It is necessary that both A and B should sign the Account opening form and the instructions for the operation.

Section 45-ZA, Banking Regulation Act, 1949 (1 of 1949) provides that the depositor or all the joint depositors may nominate any person to whom in the event of the death of the sole depositor or the death of all the depositors, the amount of deposit may be returned by the banking company. Such nominee of the depositor shall become entitled to all the rights of the depositor on the death, to the exclusion of all other persons, unless the nomination has not been varied or cancelled.

Under Section 45-ZA of the Banking Regulation Act, 1949, a person can nominate in the prescribed manner, one person to whom in the event of the death of the sole depositor or death of all the depositors, the amount of deposit may be returned by the banking company.

Saving Deposits

The commercial banks found that it was a paying business to accept such deposits, however small they might be. The advantages of such deposits to a bank are that a very small reserve is sufficient to meet the demands on them. Earlier, only limited withdrawals were permitted but now the depositor can withdraw the money whenever he needs either through a withdrawal form along with the pass-book of the account or by a cheque. A cheque book is issued to the account holder subject to the condition that he will keep a minimum balance with the bank in accordance with the rules of the bank. Only cheques payable to the customers having saving bank accounts are collected. Interest is generally allowed on minimum monthly balances and not on daily balances. Some banks, including the post-office savings banks, allow interest on deposits received up to the tenth of a month, so as to enable those receiving small salaries to deposit their money and earn interest thereon. Conditions about the operation of these accounts differ from bank to banks.

It may be observed that the Savings Deposits also form a substantial part, although in the recent years the percentage of Term Deposits has gone up because of increase in the interest rate in the long end of maturities.

Current Deposit

Although formerly current deposits did not contribute to the capital of the banks in India the position has undergone a considerable change in recent years and the amount of demand liabilities of the scheduled banks in India ranges from 15 to 20% of the aggregate deposits. This proportion varies from bank to bank and from time to time.

By taking such deposits, the banker undertakes to honour his customer's cheques as long as his account is in credit. The banker may have to suffer loss if he pays a forged cheque, or, if he pays a cheque contrary to generally crossed cheque to a non-banker, or a specially crossed cheque to a banker other than one in whose favour it was crossed, or to his agent for collection.

Where the customer opens a current account at a branch of the banking company, in the absence of an express contract to the contrary, there is an implied contract in such cases that it is the duty of the bank to pay the customer only at the branch where the account is kept, subject to instructions to transfer the amount elsewhere.

Except in large cities most banks did not allow any interest on current deposits. In cases where interest was allowed, cheques for amounts exceeding rupees one lakh were generally subject to a special arrangement. Now, as per the Reserve Bank directive no interest can be paid on current accounts. Sometimes, customers are required to maintain a minimum balance, failings which they have to pay bank charges either in the form of commission on the half-yearly turnover of the account or a certain sum of money every half year.

Recurring Deposit

The banks have in recent years started various daily, weekly or monthly deposit schemes in order to inculcate the savings habit on a regular or recurring basis. The rates of interest on these deposits are almost equal to the rates of fixed deposits. These generally range for a period of one year to ten years. In these deposits the depositor deposits a fixed amount (in multiple of Rs.5). On these deposits the interest is compounded quarterly.

9.3 OPENING OF A NEW ACCOUNT

Before opening a new account, a banker should take certain precautions and must ascertain by inquiring from the person wishing to open the account, if such person is unknown to the banker, as to his profession or trade as well as the nature of the account he proposes to open. By making necessary inquiries from the references furnished by the new customer, the banker can easily verify such information and judge whether or not the person wishing to open an account is a desirable customer. It is necessary for a bank to inquire, from responsible parties, given as references by the customer, as to the latter's integrity and respectability, an omission of which may result in serious consequences not only for the banker concerned, but also for other bankers and the general public.

As for the RBI' directives the banks are required to obtain photographs for account holder with opening account. The photograph should be kept/pasted on the ledger with the signature card.

Under the circular issued by CBDT the mentioning of Permanent Account Number (PAN) Number in Account opening form is mandatory. If the account is opened without PAN No., the person opening the account has to fill in the prescribed form, which is required to be sent to Income-tax Dept. by the Bank opening the account.

Opening an account by cash is a little different from opening an account by a cheque, as in that case, the bank has to act according to the tenor of that instrument and its collection and payment involves the banks liability to its real owner, if the proposer happens not to be its real owner. Even when an account is opened by depositing cash, but cheque is paid into it so soon as after the opening of account, the same rule is implied by law.

The failure to make the necessary enquiries the banker may enable a dishonest person to obtain, for fraudulent purposes, the possession of a cheque-book. If such a person happens to be an undercharged bankrupt; the banker might be placed in a difficult position by unwittingly allowing such a person to operate on his account with the bank. Although the banker may not intend at the time of the opening of an account, to grant an overdraft to the new customer, an overdraft may be granted inadvertently, in such a case, the importance of getting a letter of introduction or references from the new customer can be well understood.

The banker has to answer inquiries from fellow bankers about his customer's financial position; it is, therefore, desirable both in the interests of the banker as well as his customer that the former should be in possession of such information as may enable him to answer such enquiries.

If the banker fails to make the usual inquiries about the new customer, the banker may be deprived of the statutory protection given to a collecting banker under section 131 of the Negotiable Instruments Act, 1881.

Every customer is deemed to have read the rules of business of the bank and to confirm in writing his willingness to comply with and be bound by them before his account is opened. He is required to supply his banker with one or more specimens of his signature and these are usually entered in a signature book maintained for the purpose by the bank. However, the modern practice is to have the specimen signatures on cards, which are indexed and filed in the alphabetical or chronological order. Each customer's full name should be written in bold characters above his account in the ledger. The form of his signatures, his address and occupation should also be added.

In case a customer desires that his account be operated upon by another person, a mandate in writing to that effect, as well as the specimen signature of the person in whose favour the mandate is given, should be obtained by the banker. Power to draw and endorse cheques does not include power to accept bills or overdraw the account; it is, therefore, necessary that the customer's instructions to his banker should specifically state so, if he wishes the banker to allow his agent to overdraw the account and / or to accept bills drawn upon him.

With a view to facilitate the receipt of credit items paid in by a customer, bankers provide them with paying-in-slip books. The right hand portion is retained by the Bank and the counter foil is returned to the customer duly initialled by an officer or authroised member of the bank.

In the absence of a notice, explicit, or implied, the banker is not concerned with the question of the customer's title to the money paid in by him. Money may ce paid into a customer's current account by a third person, which the banker is ordinarily bound to accept. In a Joint Account the Bank has no notice about the ownership of one or the other depositor or about the quantum of share of any one of them. For the bank the depositors are its creditors and the obligation of the bank is to pay them their cheques and allow operations on the Account in terms of their instructions.

SPECIMEN FORM OF PAY-IN-SLIP FOR DEPOSITING CASH

UNITED COMMERCIAL BANK
Kamla Nagar
DELHI

A/c No ....19................
Name..

Notes			
Silver			
Rs.			

Rupees...
....

Receiving Chief

FOR CASH ONLY
UNITED COMMERCIAL BANK
Kamla Nagar

A/c No............. Delhi............19......
Paid in to the credit of ....

Particulars of Payment			
Notes:			
X 100			
X 10			
X 5			
X 2			
X 1			
Whole Rs.			
Small Coins			
Total Rs.			

....
The sum of Rupees......................
....
By..

Receiving Cashier Chief Cashier

Pay-in-Slip for Local Cheques only

PUNJAB NATIONAL BANK
(Head Office : Parliament Street, New Delhi)

C.A./S.F. A/c. No. Date

Paid in to the credit of

Amount in words Rs.

Cheque No. & Name of Bank	Rs.	P.
TOTAL		

Signature of Officer

INSTRUCTIONS
1. All Cheques must be Crossed.
2. Please use separate slips for Cheques on : (a) This Branch. (b) Clearing Banks. (c) Non-clearing.

PUNJAB NATIONAL BANK C.A./S.F. A/c. No.
Moti Bagh
New Delhi
______________________19......

Paid in to the credit of ______________________
____
Address ______________________________
Amount in words Rs. __________on Realisation

Cheque No. & Name of Bank	Rs.	P.
	TOTAL	

Receiving Officer/Passing Officer By

9.4 BANK PASS BOOK

The pass Book is a small handy book issued by a banker to his customer to record all dealings between them. In fact, it is an authenticated copy of the costumer's account in the account books of the banker. The purpose of issuing a pass book to a customer is to acquaint him periodically with the state of affairs of his account with the bank. The Pass Book also contains rules and regulations governing the savings account. The customer deposits the pass book periodically with the bank for the purpose of recording entries therein. As it passes from the hands of the customer to the banker and vice versa, it is called a 'Pass Book'.

A Pass Book is very important to a customer because it enables him to know some of the entries made by the banker in his ledger account, e.g., the amount of interest allowed or charged, the incidental or other charges made by the banker. In business where such entries are many, businessmen prepare Bank Reconciliation Statements with the help of the Pass Book to tally the balance shown in the Cash Book with that given in the Pass Book. A specimen of Pass Book in the next page.

The following points are important in this connection:

1. Entries in the Pass Book are to be recorded by the clerk of the bank and must bear the initials of the accountant. The customer should not write any entry himself, even for the purpose of reconciling the bank balance.
2. Whenever the banker sends a pass book to the customer, it must shown up-to-day entries. Recently Reserve Bank of India has advised the banks to provide full particulars of each transaction while updating the Pass Books.
3. If the Pass Book is lost by the customer a duplicate Pass Book may be issued by the banker and marked as 'Duplicate'.
4. In case of a Savings Bank Account, the Pass Book must accompany the withdrawal form every time when money is withdrawn through a withdrawal form.

Some banks, send to the customers a Statement of Account periodically, i.e., fortnightly or monthly, in place of providing the customer with a Pass Book. Such statement shows the relevant entries in the customer's account during the given period and is filed by the customer.

Legal Aspect of Entries in the Pass Book

Though the Pass Book contains true and authenticated record of the customer's account with the banker, no unanimous view prevails regarding the validity of the entries in the Pass Book. The Banker may err in recording

the entries in the Pass Book. The question, therefore, arises whether the Pass Book constitutes a conclusive proof of the accuracy of the entries made therein.

Sir John Paget's View

According to Sir John Paget, "The proper function which the Pass Book ought to fulfill is to constitute a conclusive and unquestionable record of transactions between the banker and the customer and it should be recognized as such."

His viewpoint rests on the presumption that the customer is under an obligation to verify the entries made in the Pass Book periodically and if he detects any mistake, he ought to bring it to the notice of the banker within a reasonable period. If he does not do so and remains silent after the receipt of the Pass Book, customer's concurrence with the correctness of the entries is taken for granted.

SPECIMEN OF BANK PASS BOOK

Name

Address A/c. No............

IN SAVINGS FUND ACCOUNT WITH
PUNJAB NATIONAL BANK........

Date	Particulars	Dr		Cr		Balance		Acctt's Initials
		Rs.	P.	Rs.	P.	Rs.	P.	
	Carried over							

Divergent Viewpoint

The implied obligation on the customer to examine the Pass Book has not been supported in many other judicial decisions in England and India. In the absence of such obligation on the customer, the entries in the Pass Book cannot be treated as a conclusive proof of their accuracy and as settled account.

i. The Pass Book is written by the banker and hence the entries therein may form evidence against the banker. The customer is rightly entitled to believe them as correct and to act the basis of such entries.

But the customer shall have to prove that (a) he acted in such manner relying on the correctness of the balance shown in the Pass Book and had no knowledge of the mistakes therein, and (b) he altered his position by spending the same.

ii. There are some exceptions to the above - mentioned principle of estoppel. If the customer regularly maintains his account books and the bank regularly sends him the Pass Book (or statement in lieu of the Pass Book) the customer cannot act on the basis of the above presumption. Though it is not obligatory for him to check the Pass Book (or the statements), but in such circumstances, it is difficult establish that he was ignorant about the books. In such circumstances, a constructive notice of the mistake is supposed to have been given to him.

iii. The banker is entitled to point out to the customer any mistake or omission and to rectify it as soon as he knows about it. On receipt of such information the customer is not entitled to withdraw the excess amount wrongly credited to his account. But the banker should not dishonour the cheques drawn and issued by the customer before the notice of such wrong entry is served on him. If he does so, he will be liable for the consequences of their wrongful dishonour.

PRECAUTIONS TO BE TAKEN BY THE BANKER AND THE CUSTOMER

1. The Pass Book must be sent by the customer to the bank periodically and regularly for recording the necessary entries, so that mistakes, if any, may be detected by the customer soon thereafter. Reserve Bank has advised the banks to issue a simple receipt to the tender of savings bank pass book if it is retained by the bank for updating.
2. The Pass Book must be initialed by the accountant or other responsible officer of the bank, who must ascertain the accuracy of the balance on the date of recording the entries; otherwise the customer will be entitled to act upon the same, if it is wrongly stated.
3. The customer must tally the entries with his own record - either the account books or the counter foils of pay-in-slips and cheques, etc. If any inaccuracy is found, the customer must inform the bank immediately to get the mistake rectified.
4. While sending the Pass Book to the customer, the banker should take steps to ensure the secrecy of its contents. The Pass Book must be sent in a closed cover.

9.5 CLOSING OF A BANK ACCOUNT

The relationship between a banker and his customer is a contractual one and continues as long as both of them so desire. The relationship may be terminated by either of them by giving notice of his intention to the other party. Moreover, the banker is bound to suspend payment out of the customer's

account under the compulsions of law. The rights and obligations of a banker in this regard are as follows:

1. If a customer directs the banker in writing to close his account, the banker is bound to comply with such direction. The latter need not ask the reasons for the former's direction. The account must be closed with immediate effect and the customer be required to return the unused cheques.
2. If an account remains unoperated for a very long period, the banker may request the customer to withdraw the money. Such step is taken on the presumption that the customer no longer needs the account. If the customer could not be traced after reasonable effort, the banker usually transfers the balance to an "Unclaimed Deposit Account", and the account is closed. The balance is paid to the customer as and when he is traced.
3. The banker is also competent to terminate his relationship with the customer, if he finds that the latter is no more a desirable customer. The banker takes this extreme step in circumstances when the customer is guilty of conducting his account in an unsatisfactory manner, i.e. if the customer is convicted for forging cheques or bills or if he issues cheques without sufficient funds or does not fulfil his commitment to pay back the loans or overdrafts, etc. The banker should take the following steps for closing such an account.
   a. The banker should give to the customer due notice of his intention to close the account and request him to withdraw the balance standing to his credit. This notice should give sufficient time to the customer to make alternative arrangements. The banker should not, on his own, close the account without such notice or transfers the same to any other branch.
   b. If the customer does not close the account on receipt of the aforesaid notice, the banker should give another notice intimating the exact date by which the account be closed otherwise the banker himself will close the account. During this notice period the banker can safely refuse to accept further credits from the customer and can also refuse to issue fresh cheque book to him Such steps will not make him liable to the customer and will be in consonance with the intention of the notice to close account by a specified date.

The banker should, however, not refuse to honour the cheques issued by the customer, so long as his account has a credit balance which will suffice to pay the cheque. If the banker dishonours any cheque without sufficient reasons,

he will be held liable to pay damages to his customer under Section 31 of the Negotiable Instruments Act, 1881.

c. In case of default by the customer to close the account, the banker should close the account and send the money by draft to the customer. He will not be liable for dishonouring cheques presented for payment subsequently.

4. On receipt of the notice of death of a customer, the banker must stop the operation of his account because the authority of the customer terminates as he dies.
5. If a bank receives a notice regarding the insanity of his customer, he is bound to stop payments for his account.
6. The relationship between the banker and his customer is also affected if the customer becomes insolvent or the corporate customer goes into liquidation. the credit balance of the customer is transferred to the Official Receiver of the insolvent customer.
7. On receipt of a Garnishee Order from the Court, the banker is bound to suspend payment from the account of the customer. If the order prohibits the payment of a specified sum from the account; the banker may honour the cheque out of the remainder amount.
8. When the banker has received a notice of assignment of the credit balance in the account of a customer to a third, party, the banker is bound to pay the same amount to the said third party.

9.6 INSURANCE OF BANK DEPOSITS

An important feature of Indian banking is that deposits of the public with the banks are insured up to the limit of Rs. 1 lakh in each account. After the failure of the Palai Central Bank, a scheduled bank of South India in 1960, the Government and the Reserve Bank felt the necessity of insuring the deposits in the banks so that public confidence in the banking institutions was not shaken whenever any bank failed to operate or was merged with another bank. The Deposit Insurance Corporation of India was established by an Act of Parliament to insure the deposits in the banks and the scheme of deposit insurance was introduced with effect from January 1, 1962. The Corporation was renamed as Deposit Insurance and Credit Guarantee Corporation with effect from July 15, 1978.

SALIENT FEATURES OF DEPOSIT INSURANCE

1. The scheme of deposit applies since its inception to all commercial banks in India, scheduled and non - scheduled. The deposit insurance cover has been extended to co-operative banks also in 21 States and 3 Union

Territories. The Regional Rural Banks have also been included in this scheme. All these banks are called insured banks.

2. The insurance cover is extended to all deposits with the insured banks except the deposits of the Central and State Governments, foreign Governments and the commercial banks.

3. The deposits with the insured banks are insured up to a special limit only. The insurance cover is available in respect of all unpaid balances due to a depositor held in a bank in the same capacity and in the same right up to Rs.1 lakhs. This means that every account of a depositor in every insured bank is insured to the extent of Rs.1 lakh. The accounts with credit balance up to Rs.1 lakhs each are called fully protected accounts.

4. The Corporation reimburses the depositors in case the insured bank fails or is amalgamated with another bank and defaults in paying fully the balances due to the depositors in cash or by crediting the same to the full extent in the books of the transferee banks. The difference between the amount so paid or credited and the limit of insurance cover per account is paid by the Corporation. For example, if bank X, on its merger with bank Y, gives a credit equal to 75% of the deposit, a depositor having a credit balance of Rs.10,000 will get credit of Rs.7,500. The balance of Rs.2,500 will be reimbursed to him by the Corporation.

5. The rate of insurance premium is 5 per annum for every hundred rupees of assessable deposits. It is payable by the insured banks and not by the depositors at half - yearly intervals. Assessable deposits are those deposits to which the cover of insurance is extended under (ii) above. Premium is thus payable on total assessable deposits whereas the "insured deposits" are those which are below the limit of insurance cover, i.e. Rs.1 lakh in each account.

6. The Corporation maintains two funds: (a) Deposit Insurance Fund, and (b) General Fund. The income from insurance premia is credited to the Deposit Insurance Fund and is invested in the Central Government securities. Income from such investments is credited to and the insurance loss are debited to the Revenue Account of the Fund. The General Fund meets all other expenses of the Corporation

9.7 ATTRACTIVE SAVINGS SCHEMES

Though the terms and conditions regarding deposits are largely prescribed by the Reserve Bank of India (as already discussed), the banks have recently introduced various attractive savings schemes. For example, the State Bank of India at present offers the following deposit schemes to the public:

1. Re-investment Plan: This is just like fixed deposits with the difference that deposits are accepted for a fixed period ranging between 12 and 120

months and interest, though calculated periodically, is payable at the time of maturity. This plan provides for the re-investment of interest also. According to the Reserve Bank directive, in case of premature withdrawal or renewal under such plan, compound interest with quarterly rests at prescribed rate is to be allowed. If an advance is granted against a deposit under re-investment scheme, accrued interest in also to be taken into account for determining the margin.

2. **Cash Certificates:** These certificates are issued with different face values payable after specified maturity periods. The issue prices for different maturity periods are specified in advance; for example, one can get a Cash Certificate with face value of Rs.100 after 12 months by paying Rs.92.38. Thus interest is payable on maturity.

3. **Perennial Pension Plan:** This Plan provides for (i) the payment of monthly deposit with bank in specified denomination for a period of 84 months;

   ii. The payment of monthly pension by the bank is discontinued.

   iii. Further specified sum payable to depositor when pension is discontinued.

4. **Annuity Deposit:** Under this plan the depositor opts for a monthly annuity for 36, 60, 84 or 120 months. He makes the initial deposit of the specified amount and thereafter receives monthly annuity amount for the selected period of time. For example, by making an initial deposit of Rs.1,551.50, one gets a monthly annuity of Rs.50 for 36 months (this includes principal and interest both).

5. **Super Savings Package:** Under this plan a depositor makes monthly deposits for a longer period ranging from 15 to 40 years and gets a lumpsum thereafter.

6. **State Bank Education Plan:** This plan is to help parents to save for meeting the educational expenses of their children. Parents are required to make a monthly deposit of Rs.100 per month during the period their child studies from nursery to 7th Class. Thereafter, the parents get specified sums annually when the child reaches 12th Class and completes his 5th year of University education. This plan provides for further studies including study abroad.

9.8 DEPOSIT SCHEMES FOR INDIANS ABROAD

A large number of Indian citizens and aliens of Indian origin live abroad and are in a position save a good deal of money. Banks in India at present operate various types fo deposit accounts for (i) Non - Resident Indians and (ii) Overseas Corporate bodies both in Indian Rupees and foreign currencies.

Definition of Non - Resident Indians

To open an account under any of the schemes meant for Non - Resident Indians, one must qualify as a Non - Resident Indian, by fulfilling any one of the following conditions:

1. He is an Indian citizen, who stays abroad for employment or for carrying on a business or vocation, or for any other purpose in circumstances indicating an indefinite period of stay outside India.

2. He is an Indian citizen working abroad with international organisations like the UNO, IMF etc.

3. He is an official of Central / State Government and public sector undertaking deputed abroad for temporary assignment.

4. He is a person of Indian origin. A person is deemed to be of Indian origin if he at any time held an Indian passport or he or either of his parents or any of his grand parents was an Indian and a permanent resident in undivided India at any time. Spouse of a citizen of India or of a person of Indian origin is also deemed to be of Indian origin even though his/her parents are non - Indians.

OVERSEAS CORPORATE BODIES

Overseas Corporate Bodies (OCBs) have also been permitted to open two types of accounts in India, viz., Non - Resident External Rupees Account and Foreign Currency Non - Resident Account.

An OCB is defined as a company, partnership firm, society or any other corporate body owned directly or indirectly to the extent of atleast 60% by Non - resident Indians. It includes Overseas Trust also in which not less than 60% beneficial interest is held by Non - resident Indians directly or indirectly but irrevocably.

These accounts can be maintained with banks which are authorised dealers in foreign exchange or which are specifically authorised in this behalf by the Reserve Bank. Permission of Reserve Bank is not required to open these accounts which fall in two categories:

(A) Rupee Accounts

Three types of rupee accounts are permitted to be opened in the names of Non - Resident Indians:

1. Ordinary Non - Resident Rupee Accounts (NRO Accounts)

This is just like an account opened by a resident Indian to which the local funds (funds from sources in India) are credited. These funds do not qualify for remittance outside India. These accounts can be maintained in any form, i.e., current, savings or fixed deposit accounts. Banks are free to determine

i.e., current, savings or fixed deposit accounts. Banks are free to determine the interest rates in these deposits, as in the case of domestic deposits.

2. Non - Resident (External) Accounts Scheme

The Non - Resident (External) Accounts facility was introduced by leading commercial banks several years ago. Indian nationals abroad are permitted to open current, savings or fixed deposit accounts in India. Under this scheme the unit of account is the Indian rupee. The capital and interest earned on these accounts can also be invested in the Units of the UTI., N.S.C., Govt. Securities, etc. The income earned from these investments as well as the principal realised on maturity are also repatriable. Interest on these accounts is tax free. These accounts can be opened by (i) non - resident Indians, or (ii) OCBs outside India. Other fore[not permitted to open such an account. The greatest drawback of this scheme is that the amount of principal and interest is repatriated at the current rate hence, the exchange risk is borne by the depositors, i.e., Indian nationals abroad. Effective April 16, 1997 banks are free to determine their own rates of interest on fixed deposits of over one year under this scheme.

3. Non - Resident (Non - Repatriable) Rupee Deposit Scheme (NRNR)

Under this scheme, which came into force on 15th June 1992, accounts are to be opened in Indian rupees with the authorised dealers by remitting funds in freely convertible foreign exchange from abroad or by transfer of funds from the existing Non - resident (External) / FCNR accounts. Other features of this scheme are as follows:

a. Only term deposits are accepted under this scheme. Authorised dealers are free to fix the maturity period of the deposit between 1 year and 3 years and also the rate of interest payable on such deposits.

b. On maturity, the principal amount of deposit will not quality for repatriation outside India at any time. Interest accruing on such deposits w.e.f. Oct 1, 1994 is eligible for repatriation.

c. The deposits may be renewed and may also be shifted from one bank to another, but if the amount is withdrawn or invested in other schemes, it will not quality for renewal under the scheme.

d. The account holder is exposed to the fluctuations in the value of Indian rupee to the extent of interest amount.

e. Such account may be opened by any person resident outside India.

f. Authorised dealers may allow premature withdrawal of the deposits and levy penalty for premature withdrawal as per their description.

4. Non-Resident (Special) Rupee Account Scheme (NRSR)

The Reserve Bank of India introduced this scheme with effect from April 15, 1999. Under this scheme, accounts may be opened in India Rupees by Non-resident Indians/persons of Indian Origin. The salient features of the scheme are as follows:

1. The principal amount of deposit and interest accrued thereon are not repatriable. Hence no exposure to foreign exchange risk is borne by the depositor.
2. Only term deposits for periods not less than 1 year and not exceeding 3 years are accepted.
3. Banks are free to determine interest rates.
4. This facility will not be available to overseas corporate bodies. Opening of accounts of individuals of Pakistani/Bangladeshi/Sri Lankan nationality requires approval of Reserve Bank.
5. Investment of funds held in the accounts will be governed by the exchange control regulations.
6. The account holders are permitted to freely transfer funds from NRO/ NRE/FCNR a/cs to NRSR a/cs but not vice versa.

NRNR AND NRSR Accounts Schemes Discontinued

With a view to provide full convertibility of deposit schemes for Non-resident Indians, Reserve Bank of India has discontinued the Non-Resident (Non-Repatriable) rupees (NRNR) accounts, and the Non-Resident Special Rupee (NRSR) account schemes with effect from April 1, 2002. The existing accounts in the two schemes will continue till the date of maturity only. The maturity proceeds of these accounts may be transferred to the depositor's Non-Resident (external) Rupee (NRE) accounts or at his request to Non-Resident (ordinary) Rupee a/c in case of NRNR accounts. In case of NRSR accounts maturity proceeds are to be credited to his NRO account. No NRSR a/c other than term deposit should be continued beyond Sept.30, 2002.

(B) Foreign Currency Accounts

Foreign Currency Non-Residents (Banks) Scheme, 1993

This scheme was introduced with effect from May 15, 1993. Under this scheme banks provide the exchange rate guarantee to the depositors.

Deposits of 1 year and above up to 3 years are permitted to be accepted under this scheme. The banks are not required to surrender the deposits mobilised under this scheme to the Reserve Bank. The amount collected under the scheme can be swapped either in the domestic market or with the

Reserve Bank of India. Authorised dealers are also permitted to lend the foreign currency mobilised under the scheme for certain approved purposes.

The loans under the scheme are not subject to the lending rate stipulations of the Reserve Bank of India and will not considered as a part of net bank credit for the purpose of determining priority sector lending.

Under the scheme fixed deposits in five currencies-US dollars, Pound starling, Deutsche mark, Japanese yen and EURO-are accepted by banks for maturities ranging from 1 year to 3 years.

The interest rates under the scheme were prescribed by Reserve Bank of India for specified maturities. With a view to give more flexibility to the banks, Reserve Bank of India decided that with effect from April 16, 1997 banks may determine interest rates on such deposits subject to a ceiling prescribed by Reserve Bank of India from time to time.

To provide greater flexibility to the banks, Reserve Bank has permitted the banks in Oct, 1997 to offer interest on such deposits at rates not more than the LIBOR prevailing on the last working day of the previous week for the relevant maturity and currency. Subject to this guideline, banks may offer either fixed or floating rate of interest on such deposits. In April 2002 Reserve Bank of India reduced the above ceiling rate to LIBOR rates for the corresponding maturities minus 25 basic points.

Check your progress

State True of False:

1. Competition in the business of accepting deposits improves customer service (True/False).
2. A fixed deposit is repayable on demand (True/False).
3. The request for opening a savings or current account is to made on the prescribed form of a bank concerned (True/False).
4. A passbook is a handy book issued by a banker to his customer (True/False).
5. Pay-in slips are used to deposit cash and cheque (True/False).
6. While sending the pass book to the customer, the banker need not ensure the secrecy of its contents (True/False).

Let us sum up

Competitions in the business of accepting deposits are essential for the growth of a banking industry. In the recent past Reserve Bank has regulated the interest rates on deposits so that banks can compete with each other.

There are four types of deposits mainly: Fixed deposits, saving deposits recurring deposits, current account. Each type have special features. A current

account can be opened by an institutional customer. It is a recurring account usually opened by big business men, Joint stock companies who have banking transactions which happens to be numerous on every working day.

While opening a current account with the banker, a customer enters into a relationship with a banker. The applicant should be, in introduced to the banker. The customer should provide specimen signature so as to operate the account.

The banker issues a pass book so that the customer can operate the account as per the entries recorded there in. The customer must tally the entries with his own record. While sending the pass book to the customer the banker should maintain secrecy. Every bank deposits of the public are insured upto a limit of Rs.1,00,000 in each account.

Glossary

Fixed deposit : Deposits with the bank for a fixed period of time.

Recurring Deposit : A depositor opening a recurring deposit account is required to deposit an amount chosen by him, generally a multiple of Rs.5 or Rs.10 in his account every month for a selected period.

Current accounts : A current account is a running and active account which may be operated upon any number of times during the day.

Pass Book : A handy book passing from the banker to the customer with entries recorded there in.

Answers to check your progress

1. True; 2. False; 3. True

4. True; 5. True; 6. False

Model Question

1. Discuss the provisions regarding the fixed deposits.
2. Write a short note on pass book.
3. Explain the deposit schemes for Indians abroad.
4. What procedure does a banker follow in opening a new account?
5. What procedure should a banker follow in case he decides to close the current account by its customer?

Unit 10

SPECIAL TYPES OF CUSTOMERS

STRUCTURE

Overview
Learning objectives
10.1 Types of customers
10.2 Special types of customers
10.2.1 Minors
10.2.2 Lunatics
10.2.3 Drunkards
10.2.4 Insolvents
10.2.5 Married Woman
10.3 Death of a Customer
10.4 Joint account
10.5 Account in the name of Joint Hindu Families
10.6 Account in the name of Partnership firm
10.7 Account in the name of limited companies
10.8 Account in the name of clubs and associations
10.9 Account in the name of Trusts
10.10 Accounts in the name of Executors and administrators
10.11 Accounts in the name of Liquidators
10.12 Accounts in the name if cooperative society
10.13 Account in the name of Government Department
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

As the banker customer relationship is a contractual relationship, all the essential features of a valid contract must be present when a banker opens an account. The actual formalities will differ depending on the type of the customers and certain formalities a common to all. The banker should that the customer is competent to enter into a contract.

LEARNING OBJECTIVES

After going through this unit you should be able to discuss the formalities for opening the accounts of Limited Companies, Clubs and associations, Trusts, Executor & Administrator, Liquidators, Cooperative Society, and Govemment Departments.

10.1 TYPES OF CUSTOMERS

A bank opens accounts to various types of customers like, individuals, partnership firms, trusts, companies etc. While opening the accounts, the banker has to keep in mind the various legal aspects involved in opening and conducting these accounts, as also the practices followed in conducting these accounts. Normally, the banks have to deal with the following types of deposit customers:

a. Individuals – either singly or jointly with other individuals.

b. Joint Hindu Families

c. Partnership Firms

d. Limited Companies

e. Club and Associations

f. Trusts

g. Executors and Administrators

h. Official Liquidators

i. Co-operative Societies

10.2 SPECIAL TYPES OF INDIVIDUAL CUSTOMERS

While a person opens an account if the banker is satisfied as to his bonafides certain persons lack the legal capacity to make valid agreements – minors, drunkards etc. The positions of the banker in regard to these persons and the precautions to be taken in dealing with theses classes of persons are described below:

10.2.1 Minors

According to Section 3 of Indian Majority Act, a person attains majority at the age of 18, except in cases where a guardian is appointed by a court where the age of majority is 21. According to the Indian Contract Act, a minor is under legal capacity to enter into a contract and therefore any contract with a minor is void.

Thus, the minor has to have a guardian of his person and property. In all the systems of personal law in India, his father is the natural guardian. Sometimes, the court may appoint someone who is not a natural guardian, as the minor's guardian. In such cases the account would be in the name of the minor and the court – appointed guardian. Usually, the account would be operated by the guardian on behalf of the minor. The Account Opening Form should certain details of name, age, date of birth and the date of obtaining majority of the minor, as also the name and signature of the guardian. When the minor attains majority, he alone can operate on the account and the erstwhile guardian should not be allowed to operate without reference to the minor.

Account in the Minor's Own Name: It has recently been decided that a minor can open and operate an account without the intervention of the guardian. The declaration obtained from the minor in the account opening form as to the date of birth is generally accepted without any confirmation. The questions that would then arise are:

1. Whether the minor can draw a valid cheque and
2. Whether he would, on attaining majority be bound by the withdrawals made by him when he was a minor.

As to the question (i), Section 26 of the Negotiable Instrument Act provides that a minor may draw, endorse, deliver and negotiate a Negotiable Instrument and so a minor can draw a cheque. From this it automatically follows that the bank would be bound to make payment and will be discharged if the payment is in due course – question (ii) thus stands answered.

Ordinarily balances in such accounts are subject to a maximum and the age of the minor is above 12. The account can be continued when the minor attains majority. It is advisable to take a confirmation of balance in the account signed by him immediately on attaining majority.

A banker should never allow a minor to borrow money from the bank. That is, no overdraft or loan can be given to minor and the account should be in credit. This is because, a minor can make others liable on a negotiable instrument, but he himself cannot be made liable. A minor is not personally liable for any debts contracted by him, but his estate becomes liable for debts contracted by him for his necessities. So, in a minor account operated by the guardian, a loan may be sanctioned, if it is for the interests of the minor. But no loan can be granted on minor – operated account, even against security or the guarantee of his own natural guardian.

Even though a minor is not competent to contract, he can be appointed and act as agent for another person competent to contract. That is he can be the agent of a major, say his father, but he will not be personally liable for what he does on behalf of the major.

When an account is opened by the guardian on behalf of the minor and if the minor dies, the balance in the account is paid to the guardian upon production of necessary documents.

10.2.2 Lunatics

Under section 11 of the Indian Contract Act, persons of unsound mind are disqualified from contacting, but the disqualification does not apply to contracts entered into during the periods of sanity. However, no banker would knowingly open an account in the name of a person of unsound mind because he then would have to face the difficulty of choosing whether a cheque was made

during a period of sanity and pay or it was made during a period when it was not and so dishonour it.

If a banker receives notice that an account-holder has become a lunatic he should stop all operations in the account till such time the customer becomes normal. The banker should obtain a certificate of sanity from a competent authority till such a person is allowed to operate on the account.

10.2.3 Drunkards

Generally drunkenness does not affect a person's capacity to contract. However, no one should take advantage of a person who is drunk. The drunkard can evade responsibility for an instrument if the court is satisfied that he was induced to sign the instrument under influence of liquor. If a customer tenders a cheque for payment when he is drunk, the banker should have witness to the signature and the payment.

10.2.4 Insolvents

Once an account-holder becomes insolvent, the banker should not allow operations in the account except credits to the account, because the entire balance in the account falls in the hands of the official assignee and has to be disposed off as per the court order.

10.2.5 Married Woman

An account can be opened in the name of a married woman, as she has the power to draw cheques and give discharge. But in the case of an overdraft, the banker will have no remedy against her, if she has no separate means. A married woman cannot make her husband responsible for debts incurred by her, except in cases where she acts as his agent.

10.3 DEATH OF A CUSTOMER

When a customer dies, the contractual relationship stands terminated and operations in the account should be stopped as soon as the banker receives the notice of death. The banker should also obtain a copy of the death certificate.

If the customer has left a will, the will has to be probated by a court and the amount paid to the executor or administrator of the will. In the absence of a will, the legal heirs have to obtain a Succession Certificate from the court in terms of Section 371 of the Indian Succession Act.

Depending on the circumstances of the case, the banker may also decide to waive the presentation of the Succession Certificate. In that case, he should be satisfied through discreet enquiries that the customer died intestate and that the legal heirs are not required to obtain Succession Certificate for the disposal of other assets left by him. However, the legal heirs would have to

execute a stamped indemnity form along with two sureties each good for the amount involved. The legal heirs are also required to submit an affidavit from an independent person, indicating their heir ship or submit a heir ship certificate.

For claims up to Rs.25,000 in respect of deposits of a deceased person, banker may consider without succession certificate. Deposits of deceased person lying in current and savings accounts would earn interest.

10.4 JOINT ACCOUNTS

A joint account is an account opened by two or more persons. The Account Opening Form should be signed by all the joint account holders. The names, addresses and other details of all of them should also be obtained on the Account Opening Form. The account-holders should also indicate how the account is to be operated – the banker should obtain specific directions as to one or more of them will operate on the account. When a joint account is in the name of two persons, the operations may be by,

i) both or survivor

ii) both jointly

iii) either or survivor

iv) former of survivor

v) latter of survivor

A joint account in the name of more than two persons may be payable to

a. all of them or survivors;

b. any one or more of them or survivor or survivors.

In the absence of such instructions, the operations will be by all the persons jointly. Since all the instructions are to be given by the account-holders jointly at the time of opening the account, they can not be revoked by any one of them singly. All fresh instructions and changes in the existing instructions must be given in writing signed by all the account holders. However, any one of them can stop payment of a cheque issued by any other joint account holder. Any request for granting of an advance should be made by all the parties jointly.

The instructions for operations in the account will stand countermanded and the operations in the account should be stopped till the banker receives instructions from the same account holder and a competent authority in regard to his sanity.

Insolvency puts an end to the mandate and the operations on the account will be stopped. Payments from the account should be made on the joint instructions of the trustee of the insolvent and the solvent joint account holders.

However, while returning the cheques of the solvent account holders a suitable reason has to be given so that their credit-worthiness is not affected.

As the mandate taken for the operation of the account also deals with survivorship, speaking generally, on the death of one of the joint account holders, the survivors are entitled to the whole amount both under the law of devolution applicable to joint owners and by the customer of bankers. Where the mandate is to operate by joint signatures and if one of them dies, the balance is payable to the survivor and the legal heirs of deceased.

When such an account is opened with the instruction "payable to either or survivor" there is no problem about the operation of the account so long as both are alive. The problem arises on the death of the husband – the question is whether the amount is to be paid to the wife as the survivor. Under the law prevailing in India, a deposit by a Hindu husband in the name of himself and his wife, payable to either or survivor, must, in the absence of evidence to the contrary, be presumed to belong to the husband and should therefore pass on the legal heirs of the husband, including the wife, the survivor.

10.5 ACCOUNT IN THE NAME OF JOINT HINDU FAMILIES

The concept of Joint Hindu Family is recognized by law. A business, according to the law is a distinct, heritable asset. Where a Hindu dies, leaving a business it passes on to the heirs. If he leaves male issues, it descends to them and the property becomes Joint Hindu Family property. The members of the family are called co-partners and the eldest male member is the manager of the Karta. When an account in the name of the JHF is opened all the adult co-partners are to sign the account Opening Form, even though the Karta would operate on the account. In addition, the bankers also obtain a letter of undertaking signed by all the adult co-partners stating that the business carried on by the family is an ancestral and that any changes in the constitution of the family through births and deaths will be advised to the banker. If the business is an ancestral, the co-partners are liable to the extent of their share in the family property, whereas, if the business is not an ancestral, co-partners will be personally liable for the debts incurred by the family from the bank.

The main problems in dealing with a JHF arise in respect of loans. In the JHF governed by Mitakshara law, all the members acquire a right in the property by birth and this right starts from the date of conception in the womb and so there is always the danger of a loan being repudiated by a member who was not even born on the date of the transaction. In order to charge a joint family estate, all the family members can execute the deed or give their consent or the deed may be executed by the Karta alone. The powers of the Karta are however, limited. The Karta can create a charge against the family property only if the loan for which the charge is created is taken for the purpose beneficial

or necessary to the family. The burden of proving this necessity lies on the banker and the banker has to not only prove the legal necessity, but also prove that he made reasonable enquiries and was satisfied as the existence of the legal necessity.

To avoid these and several other difficulties, some banks require a Hindu customer opening an account, to furnish a statement to the effect that the money deposited is his self-acquired property and not that of JHF.

Precautions to be taken in the case of JHF accounts:

- i. The account should clearly indicate that it is a JHF.
- ii. The JHF letter should be signed by all the co-parceners.
- iii. The letter should clearly indicate the powers of the Karta.
- iv. Names of minor co-parceners should be kept on record and their consent obtained when the attain majority.
- v. All co-parceners should sign the documents for loans.
- vi. Death/Lunacy/Insolvency of co-parceners does not dissolve the JHF. It continues till partition of property.

10.6 ACCOUNTS IN THE NAME OF THE PARTNERSHIP FIRMS

Section 4 of the Indian Partnership Act defines partnership as a relationship subsisting between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. This agreement may be oral or written. According to the Act a partnership firm doing the business of banking cannot have more than 10 partners and in other cases the number should not exceed 20.

Even though a partnership may be registered with the Registrar of Firms in terms of Section 58 of the Act, registration is not compulsory. However, unregistered firm suffer from certain disabilities according to section 69 of the Act. While non-registration does not affect the legal rights of the outsider who deal with the firm, the firm does not have the right to sue others for any cause relating to the firm's business. The partners cannot also sue the firm for wrongful Acts. Even subsequent registration does not permit such a suit.

Under Indian law, the partnership is not an entity separate from its members. All the partners are jointly and severally liable for all the acts done by and on behalf of the firm, in the normal course of business of the firm. Every partner has a right to bind the firm by his own actions, working on behalf of the firm.

A banker should always open a firm's account in the firm's name, as Section 19 (2) of the Act denies a partner authority to open a bank account on behalf of the firm in his own name. The account opening form should be signed by all the partners. The banker should also get a letter signed by all the partners, stating the nature of the firm's business, names and addresses of all the

partners. In the letter all the partners should declare themselves as partners of the firm and also give an undertaking that they are jointly and severally liable for the debts of the firm. The partners should give clear instruction as to the operation of the accounts of the firm – the names of all those authorized to operate on the account on behalf of the firm. The authority given should include powers to draw, endorse and accept bills and mortgage and sell property belonging to the firm. If this is done, a dormant partner cannot evade his liability and the banker is not put the trouble of proving the interest of all partners of the firm. Instructions to the bank authorizing an outside party to operate the bank account if given should be signed by all the partners of the firm.

While operating the accounts the banker has to be guided by the following points of law regarding the authority of the partners:

a. A partner has no implied authority to submit a dispute among partners for arbitration.

b. He has no implied authority to compromise or relinquish the firm's claims.

c. He has no implied authority to withdraw a suit filed on behalf of the firm.

d. He has no implied authority to admit a liability in any suit filed against the firm.

e. He has no implied authority to acquire any immovable property belonging on behalf of the firm.

f. He has no implied authority to transfer immovable property belonging to the firm.

g. He has no implied authority to enter into partnership on behalf of the firm.

An act of the partner is binding on the firm if done

h. in the usual course of business of partnership;

i. in the usual way of business and

j. as a partner i.e., on behalf of the firm and not solely on his own behalf.

From the very definition of the partnership, it therefore, follows that there is an implied mutual agency and so, the act of borrowing by one of the partners is binding on the firm as well as the partners.

Rules to be observed while operating the Partnership Account.

i. Partners operating on the firm's account should sign for and on behalf of the firm and not as individuals – the instrument should indicate that he was signing on behalf of the firm.

ii. Any partner has the right to stop payment of a cheque issued by any of the partners.

iii. If there is any dispute among the partners regarding the operation of the account, the operations should be stopped and fresh instructions obtained.

iv. A partner has no authority to give a guarantee on behalf of the firm and if such a guarantee is to be given, all the partners should sign it.

v. Retirement of a partner: in the case of retirement of one or more partners, the liability of such partners to the bank ceases so far as transactions after retirement are concerned. But if no notice of the retirement was given to the banker, the retiring partner will continue to be liable even for transactions made after his retirement.

vi. Death of a partner: The death of a partner has the legal effect of dissolving the firm, as his legal heirs cannot step into his shoes. The surviving partners have the right to carry on the business for the purpose of winding up.

Any cheque presented for payment should be paid only with the consent of the surviving partners. When the account is in debit balance, the operations should be stopped to fix the liability of the deceased partner and to avoid the operation of the rule in Clayton's Case.

vii. Insolvency of a partner: In the absence of an express provision in the partnership, insolvency of any partner will result in the dissolution of the firm. A cheque signed by such partner should not be honoured without the confirmation of the other partners, who may continue to operate the account for winding up the business. Any credit balance in the account can be paid to the solvent partners, as it is their business to account for the insolvent's share in the business to the trustees for the bankrupt.

viii. Partnership account and the partner's private account: A cheque payable to the firm should not be endorsed by the partner and credited to his personal account – this would amount to negligence under Section 131 of the Negotiable Instrument Act.

ix. Position of a minor: Under Section 30 the Indian Partnership Act, a minor can be admitted to the benefits of the partnership. He can therefore become a partner and act as an agent on behalf of other partners or the firm. But the minor is not liable personally for the debts of the firm.

10.7 ACCOUNTS IN THE NAME OF THE LIMITED COMPANY

Limited Companies (also known as Joint Stock Companies) are governed by the Companies Act 1956. While a company is normally incorporated under the Companies Act, a company can also be brought into existence by means of a statute by the Parliament or the State Legislature. While the company consists of share-holders, its entity is separate from that of the share-holders. For all practical purposes, the company is just like a person and can sue or be sued in its own name.

In the case of limited company, the liability of a share-holder is limited to the amount remaining unpaid on the shares held by him. The word 'limited' is required to be part of the name of the company, unless it is a Government company or a company licensed under Section 25 of the Act.

Companies can be broadly divided into three categories:

i. **Public Limited Company:** Should have a minimum of at least 7 members (share-holders), but there is no maximum limit.

ii. **Private Limited Company:** Must have at least 2 members, but not more than 50 members excluding those who are in the employment of the company at the time of share allotment. In the case of banking companies, the maximum number of members is 20.

iii. **Government Companies:** These are companies where 51% shares of the shares are held by the Government.

The banker should obtain Certified Copies of the Memorandum and Articles of Association as amended upto date. These documents govern the working of the company. The Memorandum of Association lays down the objects of the company and limits the scope of its operations to specific areas. The Articles of Association deal with the rules and regulations governing the internal management of the company – it defines the powers of the directors, officials and share-holders. These documents can be amended or altered by passing a resolution at a general meeting of the share holders and having it confirmed by the Company Law Board.

The directors of a company have to function within the limits of the power conferred by the Articles of Association and when the do so, their acts are binding on the company. If the directors' act in excess of the power conferred, but within the purview of the objectives and functions laid down in the Memorandum of Association, such acts can be ratified by a general meeting of the share-holders. But, if the acts are outside the scope laid down in the Memorandum of Association, they will be ultra virus of the company and will not be binding on the company. The directors will be personally liable for such acts.

A copy of the certificate of Incorporation should also be obtained. A company comes into business only after the issue of this certificate by the Registrar of Companies. The banker should also verify the original of this certificate.

In the case of Public Limited Companies, the banker, should also obtain a copy of the certificate of commencement of business issued by the Registrar of Companies – this is not necessary in the case of private limited companies. If the account is opened before the issue of this certificate, the banker should not issue the cheque book and should not permit withdrawals until it is obtained – deposits into the account can, however, be accepted.

If the banker is in doubt about any of the above documents, he can inspect the company's files with the Registrar of Companies. The banker should also obtain a certified copy of the resolution passed by the Board of Directors authorizing the opening of the account, execution of documents and conduct of the accounts. The copy of the resolution should be certified by the Chairman of the meeting at which the resolution was passed and counter-signed by the secretary of the company. In case there is a change of such authorized signatories, a fresh resolution would have to be passed. A resolution will remain in force until it is revoked by a fresh resolution.

The account opening form should be filled in and signed by the authorized signatories.

The specimen signature of the directors and the authorized signatories should be obtained. A list of directors' to be obtained. The list should be signed by the chairman and updated. Introduction is not necessary for opening a company account.

Issue of cheques by the company: If the company is to be bound by a Negotiable Instrument, it should show, on the face of it, that it has been drawn, made, accepted or endorsed by the company. This may be done either by showing the name of the company itself or by the statement of the person signing the instrument that he is doing so on behalf of the company.

As the company has an existence separate from that of the share-holders/ directors, the death of a director does not affect the operations in the account. Even, if a cheque signed by an authorized director who is dead, is presented after his death, the banker cannot return the cheque.

A cheque payable to the company should never be deposited in the personal account of directors, as it would amount to negligence under Section 131 of the Negotiable Instrument Act.

The purpose of the advance should be within the scope of the Memorandum of Association of the company – if it is not, the advance will not be binding on the company.

The Memorandum of Association should specifically empower the company to borrow. In case it does not, the Memorandum will have to be suitably amended. This does not apply to trading companies.

Section 293(1)(d) of the Companies Act provides that the Board of Directors of a Public Company or the subsidiary of a Public Company shall not borrow limits in excess of the company and its free reserves. If such amounts are to be borrowed, it should be only after consent of the share-holders in a general meeting. This section does not apply to private companies which are not subsidiaries of public companies.

Section 125 of the Companies Act provides that all charges created on a company's assets (except pledge) have to be registered with the Registrar of Companies within 30 days of creation of the charge. Otherwise, the charge is void. The following charges need to be registered:

i. securing any issue of a debenture;

ii. uncalled share capital;

iii. any immovable property and interest therein;

iv. any immovable property and interest therein;

v. book debts;

vi. movable property, other than pledge;

vii. floating charge on any undertaking or any property including stock-in trade;

viii. on call made, but not paid;

ix. ship or any share in a ship;

x. goodwill, patent or licence under a patent, trademark copyright or licence under a copyright.

While a charge may be registered even after 30 days, subject to certain formalities, a duly registered subsequent charge will get priority over the earlier charge which has been created. A banking company cannot grant advances to any of its directors or to any company in which any of its directors are interested as per Section 20 of the Banking Regulations act. In the case of winding up of a company all the powers of the directors will cease from the commencement of the winding-up except to the extent sanctioned by the liquidators or at the general meeting. The banker should not honour cheques drawn by directors after he has received the notice of resolution for winding the company.

10.8 ACCOUNTS IN THE NAME OF CLUBS AND ASSOCIATIONS

Clubs and Associations, Committees, Funds etc., are non-trading organizations. They have no legal entity, unless they are incorporated under

the Companies act. As they have no contractual powers, they cannot be sued. The individual members of such organizations are not liable for any overdraft as long as the members are signing the cheques do so in their representative capacity and not in their personal capacity.

If the Society or Club is registered under the Societies Regulation Act, 1960 or Companies Act, a copy of the Registration Certificate or the Certificate of Incorporation should be obtained. The bank should obtain certified copy of the by-laws, rules and regulations. The list of the members of the Managing Committee is to be obtained. A certified copy of the resolution passed by the committee, to open a bank account, together with the details of authorized signatories and instruction regarding the operation of the account should be obtained. The account must be properly introduced.

No advance, not even a temporary overdraft should be permitted. If the person authorized to operate on the account has his personal account also in the bank, the banker has to ensure that no cheque payable to the club/association is credited to the signatory's account and no transfer of funds takes place from the club/association account to the signatory's account. Only clubs/associations etc. meant for charitable purposes, registered under the Societies Registration Act are eligible for interest on their Saving Accounts.

In the case of death or resignation of an authorized signatory, the operations in the account should be stopped until the receipt of the fresh resolution, appointing new signatories.

10.9 ACCOUNTS IN THE NAME OF TRUSTS

A trust is an obligation annexed to the ownership of property, arising out of confidence reposed in and accepted by him for the benefit of another or of another and the owner. The person who reposes or declares confidence is called the AUTHOR of the trust. The person who, accepts the confidence is called the TRUSTEE. The person whose benefit the confidence is accepted is called the BENEFICIARY. The subject matter of the trust is called the TRUST PROPERTY or TRUST MONEY. The beneficial interest of the beneficiary is his right against the trustees as owner of the trust property. The instrument by which the trust is created is called the TRUST DEED.

Copy of the Trust Deed should be obtained and kept on record after verification with the original. The title of the trust account should tally with the provisions of the trust deed. If the trust deed indicates the name of a specific bank, the trust account should be opened only with that bank.

In the case of a charitable trust, in most states they have to be registered with the Commissioner of Charities and a copy of this certificate should be obtained. The resolution passed by the trustees for opening the account should be obtained.

When the account is opened in the name of two or more trustees, the banker should have clear instructions as to who shall operate the account. In the absence of such instructions, the account must be operated by all jointly, because the appointment of several trustees is taken to mean that the property shall be under their joint control. The trustees cannot delegate their powers unless they are specifically authorized to do so by the trust deed. The banker should be fully conversant of and strictly adhere to the provisions of a trust deed while permitting operations in the account. Instruments payable to the trust should not be credited to the personal accounts of the trustees nor should transfer of funds from the trust account to the trustee's personal account be permitted. In case the banker comes to know that the funds deposited belonging to a trust fund and they are being misapplied, he cannot escape liability on the ground that the bank account was in the name of a trustee. The banker who has knowledge of the trust character of an account and who allows transfer of funds from the trust account to the trustee's personal account is liable to refund the money to the trust.

In the case of death of retirement of a trustee or trustees, the banker cannot assume that the remaining trustees possess full powers to deal with the trust property.

10.10 ACCOUNTS IN THE NAME OF EXECUTORS AND ADMINISTRATORS

A person to whom the execution of a will is entrusted by the deceased (testator) is called the executor of the will. The executor has to obtain the confirmation of the will from the court in the form of a letter of probate.

If a person dies without leaving a will (intestate), the court appoints a person to look after the property under a letter of Administration. Such a person is called the administrator.

A copy of the probated will or the Letter of Administration should be obtained, verified with the original and kept on record. The title of the account should be "ABC executors/administrators to the estate of XYZ deceased" The account should be properly introduced.

All the executors/administrators should operate the account jointly, unless there are instructions t the contrary in the probate/Letter of Administration. In case executors/administrators borrow moneys to discharge debts or obligations of the deceased, they are personally liable for the advances, unless they are secured by specific assets of the deceased. The banker should ensure that no credits meant for the account of the estate of the deceased is made to the executor's/administrator's personal account and there should be no transfer of funds from the deceased's estate to their personal account. An executor/administrator cannot borrow money to bind the estate.

10.11 ACCOUNTS IN THE NAME OF LIQUIDATORS

A liquidator is a person appointed by the court to wind up the affairs of a company. His business is to realize the company's assets and apply funds thus collected in the repayment of debts and distribute the balance amount share-holders. He has powers to borrow money on the security of the company's assets and to draw, endorse and accept instruments on behalf of the company. While exercising such powers, the liquidator is free from personal liability. Every official liquidator is required to maintain a personal ledger account with RBI or SBI or Nationalized Bank in terms of the court order.

A copy of the court order should be obtained and verified with the original and then retained. The account should be titled in the following manner: "ABC, Official Liquidator, XYZ Co.".

Liquidators cannot delegate their power to third parties. When more than one liquidator is appointed they may not authorize less than two or three members to sign cheques etc. Like trustees, executors and administrators, the capacity of the liquidator is fiduciary in nature and the rules in respect of credits and transfer of funds to the personal accounts should be followed.

10.12 ACCOUNTS IN THE NAME OF COOPERATIVE SOCIETY

These are established under the Co-operative Societies Act in force in various states. They are governed by their respective rules and by-laws. Before opening the accounts, these have to be scrutinized to see if there are any restrictions on opening bank accounts. In some states, the co-operative Societies cannot open accounts with commercial banks without permission from the Registrar of Co-operative Societies and the Registrar may also impose certain conditions like maximum balances. All such conditions should be observed while opening and operating the accounts.

10.13 ACCOUNTS IN THE NAME OF GOVERNMENT DEPARTMENT

The Central Government transactions are governed by the Central Governmen compilation of Treasury rules and the account Codes vol. I & II. State transactions are governed by State Financial Handbook of that state.

The main function of banks in conducting government business consists c paying, receiving, collecting and remitting money on behalf of the governmer department.

The payment is through challans made in duplicate or triplicate as require showing distinctly, the nature of payment and the head of account of whic the amount is to be credited. The challan must be passed by the treasur sub-treasury before being presented. Passed challans are valid for 10 day after which they will have to be revalidated. In order to avoid misuse of duplicat

challans as duplicate receipts, the copies of challans returned to the depositor as receipt should be signed in full and the other copies should be only initialed. In case a challan is lost, no duplicate is to be issued, but only a certificate is to be issued. If cheques on local banks are accepted instead of cash for the challan, the receipt should be released only after the cheque is realized.

A claim for the payment from the government will be made either in the form of a bill or any other voucher in the prescribed format duly receipted and where necessary, stamped. All such bills are presented for passing to the treasury who then send it to the bank duly passed for payment.

These are certain government departments like, Forest Department, Local Funds etc., authorized by the Accountant General. Cheques drawn by authorized officials in these departments will be presented at the bank direct for payment without the intervention of the treasury. They are governed by the Negotiable Instrument Act and payments will be made in accordance with the Act, Personal Deposit Account will be maintained by the bank on the lines of Current Accounts. The authority for opening the account, the details of cheque books issued, persons authorized to draw cheques, whether drawings are without limit or subject to restrictions etc. will be noted in the ledger. The cheques issued are current for 3 months – they are payable upto the third month from the date of issue – i.e., a cheque issued on any date in January is payable up to 30th April. In case of a lost cheque, n receipt of advice from the drawing officer, the bank will register a stop-payment and acknowledge. A non payment certificate will be issued by the Treasury Officer and not by the bank.

At the time of retirement, the pension of a government employee has to be sanctioned by a competent authority. Then the Accountant General issues the pension payment order in two halves: one is known as the disburser's half and is kept in the Treasury at which the payment is to be made and the other is delivered to the pensioner. The pensioner will produce his half to the Treasury Officer at the time of claiming payment with a bill on the prescribed form signed and receipted by him. he may also receipt the bill and endorse it to the bank to collection. The pension can also be paid directly by Public Sector Banks on similar procedure and credited to a specific Savings account of the pensioner maintained for this purpose. The account should be in the single name of the pensioner only and the account should be used for only credit of pension amount and withdrawals of the same.

Check your progress

State whether True or False:

1. Introduction in all deposit accounts is compulsory. (True/False)
2. A minor below age of 7 can open and account independently. (True/False)
3. When a customer dies contractual relationship between the bank and the customer is terminated. (True/False)
4. If customer tenders a cheque for payment when he is drunk the bank should not have witness at the time of signing and the payment. (True/False)

Let us sum up

Banks can open account in the name if individuals, singly or jointly, Joint Hindu families and partnership. An important point to be considered while opening the account is that the customer should be properly introduced. Introduction is compulsory as per the RBI guidelines.

Accounts can be opened in the name of limited companies after getting the certified copy of articles and memorandum of associations. In the case of clubs and associations registration certificates are essential. Copy of trust deed should be give o the banker while opening an account in the name of the Trust Bankers open account in the name if government department for receiving and making payment on behalf of the concerned department of the State and Central Government and also for making pension payments.

Glossary

Author : The person who declare the confidence is called the author.

Executor : A person to whom the execution of a will is entrusted by the deceased is called the executor the will.

Beneficiary : The person for whose benefit the confidence is accepted is called the beneficiary.

Answers to check your progress

1. True 2. False 3. True 4. False

Model Questions

1. Explain the provisions to be followed while opening accounts in the name of limited companies.
2. What re the different types of customers.
3. Who is an executor? What for formalities to be adopted while opening a account by an executor?

BLOCK IV

CHEQUES

Unit - 11 : Essentials of a valid cheque

Unit - 12 : Crossing of cheques

Unit - 13 : Endorsement of cheques

Unit - 14 : Holder and Holder in due course

Unit - 15 : Payment of cheques

Unit - 16 : Collection of cheques

Unit 11

ESSENTIALS OF A VALID CHEQUE

STRUCTURE

Overview
Learning Objectives
11.1 Definition of a cheque
11.2 Parties to a cheque
11.3 Magnetic Ink Character Recognition
11.4 Essentials of a valid cheque
11.5 Marking of a cheque
11.6 Difference between Bill of Exchange and cheque
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

Section 6 of the Negotiable Instrument Act defines a cheque as "A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand". The cheque is a negotiable instrument. The cheques are payable either to order or to the bearer.

LEARNING OBJECTIVES

In this unit the following are discussed:

- Essential of a valid cheque
- Magnetic Ink character Recognition
- Differences between a bill of exchange and a cheque

11.1 DEFINITION OF CHEQUE

"According to Section 6 of the Negotiable Instrument Act of 1881, "A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand." To understand this definition, it is necessary to know the definition of the bill of exchange. Section 5 of Negotiable Instrument Act defines 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".

In other words, a cheque is a bill of exchange with the following two additional requirements:

a. A cheque is always drawn on a specified bank and

b. A cheque is always payable on demand. Thus a cheque must contain an unconditional order on a specified banker to pay a certain sum of money.

11.2 PARTIES TO A CHEQUE

There are three main parties in a cheque.

a. Drawer: It is a person who makes the cheque. He is the maker of a cheque.

b. Drawee: It is a banker who is directed to pay the amount of the cheque, i.e., on whom the cheque is drawn. In case of a cheque, the drawee is always a banker.

c. Payee: It is person to whom the amount on cheque is payable.

General specimen of a MICR Cheque:

................20.....

Pay...

....or BEARER | Rs.

| A/C No. | | LF INTLS |

State Bank of India
Masjit Moth, New Delhi 110 048
MSBL/59

11.3 MICR – MAGNETIC INK CHARACTER RECOGNITION

Technology is the process of making Mechanical sorting of instruments possible by having relevant information printed/encoded thereon in magnetic ink, thereby making it intelligible to computers. Such relevant information is printed/encoded on a specified area on the instrument. The MICR technology has been initially introduced in the metropolitan cities viz. Bombay, Calcutta, Madras and New Delhi 1987-88. It was further extended through out the country. With a view to speeding up the cheque clearing process, both local as well as inter city, the Reserve Bank of India has introduced mechanized cheque processing system. Under this system, the cheques are processed at high speed on machines. Banks issue cheques, draft and other payment instrument in MICR format using special quality paper and printing specifications on MICR. Instruments there is code line at the bottom containing information printed in magnetic ink, referring to:

a. First 6 numbers indicate the cheque number.

b. Next three numbers indicate bank code

c. Next three numbers indicate branch code

d. After some space there is a number for transaction code indicating saving or current account.

For speedier clearance banks have given some do's and don'ts, e.g.

a) Crossing on the cheque should be done only on the top left hand corner, when required.

b) The cheque should not be folded or creased.

c) Signature, stamp, pins, staples etc., should not appear on the MICR code or Band as these will damage the code line and hindered mechanized processing of such cheques causing delays in their clearance.

Benefits of MICR Cheque:

The introduction of MICR technology, will facilitate prompt handling of large volumes of clearing instruments reduce clearance time for local as well as out station cheques payable at such metropolitan cities and enable swift and better customer service.

11.4 ESSENTIALS OF A VALID CHEQUE

Following are the essential elements of a valid cheque:

1. It must contain all the essentials of a bill of exchange.

   a. It must be in writing.

   b. It must contain an express order to pay. However, the order to pay may be in the form of a request.

   c. The order to pay must be unconditional, i.e., not depend upon the happening of an uncertain event.

   d. It must contain an order to pay in terms of money only.

   e. It must contain an order to pay a definite or certain sum of money.

   f. It must contain 3 parties namely, the drawer, the drawee and the payee.

   g. It must be signed by the drawer.

2. A cheque is always drawn on a specified banker to be valid.

3. A cheque must be payable in demand always.

4. Cheques do not require acceptance and need not be stamped.

All cheques are bills of exchange, but all bills of exchange are not cheque.

11.5 MARKING OF A CHEQUE

The term" marking of a Cheque" may be defined as the writing on a cheque by the drawee banker that it would be honoured when duly presented for payment. A cheque may be marked with words "approved" or "good". The marking of a cheque may be made by the drawee banker at the instance of the drawer, or the holder or the collecting banker. The effect of marking is that the payee is certain to get the payment. In some places, there is a customer among bankers to mark cheques as 'good for payment'. It may be noted that the marking of a cheque does not amount to an acceptance. Marking is done. Where the payee is not likely to part with his goods in return for a cheque drawn by a party not well known to him the banker on whom the cheque is drawn may be asked by the customer to mark the cheque as good for payment. By initialing a cheque by the bank on whom it is drawn, it shows on the face that the cheque was drawn on good faith on funds sufficient to meet it. When such marking by usage amounts to an undertaking by the bank to honour it, it adds the credit of the banker to that of the drawer. The liability of the banker depends upon the contractual relationship between the banker and its customer.

There is no provision in the Negotiable Instrument Act about marking of cheques. The practice of marking cheques cannot be looked upon with favour by bankers and such a practice is not recognized in India. A bank may, instead of marking his customer's cheque, offer its own cheque provided the customer has sufficient balance or credit limit. In practice, the bankers have stopped marking of cheques and started issuing banker's payment order.

11.6 DIFFERENCE BETWEEN A BILL OF EXCHANGE AND A CHEQUE

a. Bill of Exchange is usually drawn on some person or a banker.

   A cheque is always drawn on a banker.

b. Bill of exchange may be payable on demand or after the expiry of a fixed period.

   A cheque is always payable on demand.

c. Bill of Exchange requires acceptance before the payment can be demanded from the drawee. The drawee becomes liable to pay the amount due on the bill of exchange only when he accepts the bill. A cheque does not requires any acceptance. However, the banker is liable to pay the amount of cheque only if there is sufficient amount in drawer's account.

d. There is no provision regarding the crossing of bills of exchange.

A cheque can be crossed. The payment of a crossed cheque can be obtained only through the bank account.

e. Bill of Exchange cannot be made payable to bearer on demand.

A cheque can be made payable to bearer on demand.

f. A bill of exchange must be stamped, whereas, a cheque does not require stamping.

g. In case of dishonour of a bill of exchange, the notice of dishonour must be given to the drawer, otherwise, he will not be liable for payment. If a cheque is dishonoured, the notice of dishonour is not required.

h. The drawer of a bill of exchange is discharged from liability if the bill is not presented to the acceptor for payment. The drawer of a cheque is not discharged from liability if the cheque is not presented.

i. Three days of grace period is allowed from the due date within which payment should be made in the case of a bill of exchange. There is no grace period for a cheque.

j. If the bill of exchange is dishonoured, it is generally "noted" or "protested" for dishonour. In case a cheque is dishonoured, it is not required to be noted or protected.

k. The payment of bill of exchange cannot be countermanded, i.e. the drawer of a bill of exchange cannot stop the other parties from making payment.

The payment of a cheque can be countermanded, i.e., the banker can stop the payment of a cheque in certain circumstances.

Let us sum up

A cheque is a bill of exchange drawn on a specified banker payable on demand. It contains an unconditional order. There are three parties in a cheque namely drawer, drawee and a payee.

To speed up clearing process the Reserve Bank of India introduced Magnetic Ink Character Recognition Cheque. This facilitates prompt handling of large volumes of clearing instruments.

The essentials of a valid cheque are that it contains all the essentials of a bill of exchange. In addition it is always drawn on a specified banker and payable on demand. All cheques are bills of exchange, all bills of exchange are not cheque. A cheque may be marked "good" or "approved", though this custom is not in practice. Instead the banker offers its on cheque to the customer provided there is sufficient balances.

A bill of exchange and a cheque differs in may aspects, manly being a Bill of Exchange is drawn on some person or a balance whereas a cheque is always

drawn on a banker. A bill of exchange may be payable on demand or after the expiry of a fixed period whereas a cheque is always payable on demand.

Glossary

Cheque : A cheque is a bill of exchange drawn on a specified banker payable on demand.

Bill of exchange : It is a Negotiable Instrument in writing containing an unconditional order directing a certain person to pay a certain sum of money.

MICR : Magnetic Ink Character Recognition cheques are instruments where there is a code line at the bottom containing information printed in magnetic ink.

Marking of a Cheque : It may be defined as the writing on a cheque by the drawee banker that it could be honoured when duly presented for payment.

Check your progress

State whether True or False

1. A cheque is not payable on demand (True/False)
2. Bill of Exchange contains an unconditional order (True/False)
3. A cheque is always drawn on a specified bank (True/False)
4. The person to whom the amount on cheque is payable is called Drawer (True/False)
5. The first 6 numbers in MICR cheque indicate the cheque number (True/False)
6. A cheque can also be drawn orally (True/False)
7. Negotiable Instrument Act clearly lays the provision for marking of cheque (True/False)

Answers to check your progress

1. False 2. True 3. True 4. False

5. True 6. False 7.True

Model Questions

1. Write a short note on MICR.
2. Define a cheque and enumerate its essential features.
3. Is marking of cheques practiced in India. Explain.
4. Differentiate between a cheque and bill of exchange.

Unit 12

CROSSING OF CHEQUES

STRUCTURE

Overview
Learning objectives
12.1 Meaning of crossing
12.2 Types of Crossing
12.3 What does not constitute crossing
12.4 Persons who can cross the cheques
12.5 Issue of cheques
12.6 Loss of cheque in transit
12.7 Transfer of cheques
12.8 Reserve Banks directive on account payee cheque
12.9 Double Crossing
12.10 Obliterating a crossing
12.11 Opening of Crossing
12.12 Liability of Paying Banker on crossed cheques
Let us sum up
Glossary
Answer to check your progress
Model Questions

OVERVIEW

After a cheque is drawn the drawer may cross, normally by drawing two parallel transverse lines on the face of the cheque. Crossing ensures safety in case of theft. The practice of crossing cheques developed gradually with the growth of commerce and industry as a means of protection.

LEARNING OBJECTIVES

Crossing being a n important aspect to protect the drawer, this chapter highlights the different types of crossing, what does not constitute crossing and who can cross a cheque.

12.1 MEANING OF CROSSING

Crossing first originated in England when cheques were sent from one bank to another. There was the possibility that a cheque might fall in the hands of wrong or unauthorized parties and thereby the original holder was likely to be put to a loss or inconvenience. To avoid this disadvantage the banker's introduced the system of crossing of cheques. Crossing automatically means

that a cheque should be presented for payment through a bank. The main object or purpose of crossing is to ensure that the money should be transmitted safely through the cheque and the amount of the cheque should reach the hands of the rightful owner. In case it is encashed by unauthorized persons, it helps to detect the parties to whom the amount has been paid. Therefore, crossing, in short, protects the holder of the cheque and reduces the possibilities of fraud.

A cheque is an unconditional order drawn on a specified banker and is payable on demand. However the drawer of the cheque can give specific instruction to the paying banker regarding the mode of payment of the cheque. The specific instruction is done by crossing the cheque. Crossing is an "instruction" given to the paying banker to pay the amount of the cheque through the banker only and not directly to the person presenting it at the counter.

There are two types of cheques, namely, open or uncrossed cheque and crossed cheque. Payment of the open cheque is made at the counter of the bank on its presentation. When an open cheque is stolen or lost, the wrong person may go to the banker and take away the payment unless it is stopped by the drawer. In order to avoid such risks and to protect the interest of the original genuine holder, the system of crossing the cheques was introduced.

Section 123 to 131 of the Negotiable Instruments Act contains provision relating to crossing. According to Section 131 A, the provisions in these sections are also applicable in case of drafts.

12.2 TYPES OF CROSSING

a. **General Crossing:** According to Section 123, "where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof between two parallel transverse lines, or two parallel 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".

Thus the drawing of two parallel transverse lines on the face of the cheque constitute "general crossing". The lines must be

- On the face of the cheque.
- Parallel to each other

The following are specimens of general crossing.

Specimen: 1

Specimen: 2

& Co

Specimen: 3

Not negotiable

Specimen: 4

Not negotiable & Co

It may be noted that when a cheque contain a general crossing, the banker on whom it is drawn shall not pay it in any other way except to a collecting banker. Thus, the payee or the holder of the cheque can get it collected only by opening an account with some banker. The effects of using different words in general crossing as shown in above specimens are:

- ★ Specimen 1: General crossing with two parallel lines. This is simple crossing which prohibits the banker to make cash payments at the counter.
- ★ Specimen 2: General crossing containing words "and co" between two parallel lines. Here also payment is to be made through the bank.
- ★ Specimen 3 & 4: General crossing containing the words "not negotiable", not negotiable and co". In addition to the above mentioned effects the endorsee cannot get a better title than that of the endorser in this type of crossing.

b. Special Crossing: According to Section 124, "When a cheque bears across it's face an addition of the name of the banker either with or without the words "not negotiable", that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially to that banker". Thus, when inside the two transverse parallel lines across the face of the cheque, the name of the particular bank is written, it is known as special crossing. The name of the banker to whom the cheque is crossed may be written without any parallel lines. Special crossing differs from general crossing because in case the former inclusion of the name of the banker is essential whereas in general crossing, drawing of two parallel transverse lines is a must. The special crossing on the cheque is a direction to the paying banker to honor the cheque only when it is presented through the bank mentioned in the crossing and no other bank. The banker, to whom a cheque is crossed specially, may appoint another banker as its agent for the collection of such cheques. Specimens of special crossing are given below:

Specimen 1:

Canara bank

Specimen 2:

Canara Bank & Co

Specimen 3:

Canara Bank Not negotiable

In special crossing, the payee or the holder can get it collected only by opening an account with the specified banker whose name appears across the cheque.

c. Restricted crossing: A cheque is said to be restrictive crossing when the words "Account payee" or "Account payee only" are added to the crossing. It may be done in the case of general crossing or special crossing. The words "not negotiable" can also be added to a restrictive crossing. Specimen of restrictive crossing is given below:

Specimen: 1

Account payee

Specimen: 2

Account payee Canara bank

Specimen: 3

Account payee Not negotiable

In actual practice, the restrictive crossing hinders negotiability of the cheque because no banker would like to collect it on behalf of any other person except the payee.

12.3 WHAT DOES NOT CONSTITUTE CROSSING?

Sections 123 and 124 of the Negotiable Instruments Act define two types of crossing in very clear terms. The inclusion of any other word/ words without the essential ingredients of crossing on the face of a cheque does not constitute crossing. For example:

★ Cheque bearing a single lines across its face or simply a 'X' mark is not a crossed cheque.

★ Inclusion of any other word within two parallel lines is irrelevant and the cheque is still deemed to be a crossed cheque for example:

under Rs, 500   & co , Chennai

★ Cheque bearing the words "not negotiable" without two transverse lines is not a crossed cheque.

★ In special crossing the name of the bank is essential otherwise it is not a crossed cheque.

12.4 PERSONS WHO CAN CROSS THE CHEQUES

The following persons are authorized to cross the cheque:

a) **The drawer:** The drawer is entitled to make general, special or restrictive crossing on the cheque before issuing it.

b) **The Holder:** The holder is entitled to cross the cheque after receiving it. He can cross the cheque in any of the following ways:

- ★ Where the cheque is uncrossed, the holder may make general, special and restrictive crossing.
- ★ Where the cheque contains a general crossing, the holder may convert it into special crossing by adding the name of some banker,
- ★ Where the cheque contains a general of special crossing the holder may ad the words "not negotiable".

c) **The banker:** The banker is entitled to cross the cheque after receiving it for collection of payment. It may make a special crossing of the cheque to another banker for the purpose of collection of payment for the drawee banker (i.e., paying banker). Thus a banker, whose name spears across the cheque, can again make a special crossing on it to another banker to act as an agent of the former for collection.

The important point in connection with the crossing of cheques is that a general crossing can be converted in to special crossing, but a special crossing cannot be converted into general crossing. If the holder converts the special crossing into general crossing by striking out the name of the banker, it will amount to material alterations which make the cheque void. It may be noted that a special crossing can be made only once except where the second special crossing is made by a banker to another banker to act as an agent of the former, for the collection of payment.

12.5 ISSUE OF CHEQUE

Unless the cheque is handed over in a complete form it the payee, with the intention that the proceeds thereof shall be paid to him or his order, or to the bearer, it is not regarded as issued. The liability of the drawer commences with the proper issue of the cheque and is unaffected by the act that the issue thereof resulted from fraud practiced upon the drawer. If the cheque gets into the hands of the holder in due course, a valid delivery of the same by all prior parties, so as to make them liable to him is presumed until the contrary is proved.

12.6 LOSS OF CHEQUE IN TRANSIT

It is advisable for mutual safety that cheques sent by unregistered post, should be specially crossed. However, should a bearer uncrossed, or a generally

crossed cheque be sent by ordinary post at the request of the payee and should it be stolen in the course of transit by a thief who is successful in receiving payment for the same, the loss will have to be borne by the payee on the ground that he employed the post office as an agent. However, mere sending of a cheque by post does not amount to delivery.

12.7 TRANSFER OF CHEQUES

A bearer cheque is transferable by mere delivery whereas order cheque can be negotiated only by endorsement and delivery.

12.8 RESERVE BANK'S DIRECTIVE ON ACCOUNT PAYEE CHEQUE

Reserve Bank of India has issued a circular to the banks emphasizing the following points regarding account payee cheques:

- ★ Crediting of proceeds of account payee cheques to parties other than that clearly delineated in the instruction of the issuers of the cheques is unauthorized and should not be done in any circumstances.
- ★ If any bank credits the account of a constituent who is not the payee named in the cheque without proper mandate of the drawer, it would do so at its own risk and would be responsible for the unauthorized payment. Banks indulging in deviations could invite severe penal action.
- ★ In case of an account payee cheque where a bank is a payee, the payee bank should always ensure that there are clear instructions for disposal of proceeds of the cheque from the drawer of the cheque. If there are no such instructions the cheque should be returned to the drawer.

12.9 DOUBLE CROSSING

A cheque bearing a special crossing to be collected through the banker specified therein. A cheque cannot have two special crossing. However, if the banker to whom a cheque is specially crossed does not have a branch at the place of the paying banker, then the cheque may be crossed to another banker who acts as an agent for collection. In such a case, the latter crossing must specify the banker to whom it has been specially crossed again. Double crossing is done as follows:

Indian Bank to State Bank of India As Agent for collection

12.10 OBLITERATING A CROSSING

If the crossing on a cheque is obliterated or erased by a dishonest person so cleverly and skillfully that the paying banker is unable, despite utmost efforts on his part, to detect such obliteration and pays the cheque as an open cheque,

then section 89 provides statutory protection to the paying banker, provided the following conditions are fulfilled:

★ The cheque does not appear to be crossed one at the time of presentation or the obligation of the crossing is not apparent; and

★ The payment is made according to the apparent tenor of the cheque and in due course.

The paying banker is discharged from his liability if such cheque is paid at the counter on presentment.

12.11 OPENING OF THE CROSSING

If the crossing on a cheque is cancelled, it is called opening of the crossing. The cheque thereafter becomes an open cheque. Only the drawer of the cheque is entitled to open the crossing of the cheque by the writing the words "pay cash' and canceling the crossing along with his full signature. The paying banker must be very careful in ascertaining the validity or genuineness of the drawer's signature opening the crossing.

12.12 LIABILITY OF PAYING BANKER ON CROSSED CHEQUES

Section 126 of the Negotiable Instrument lays down this duty of the paying banker as follows:

"Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker and where a cheque is crossed specially, the banker on whom it is drawn shall not pay it , otherwise than to the banker to whom it is crossed or his agent for collection."

Therefore, so long as the banker pays a crossed cheque in due course in the above manner, he incurs no liability even to the true owner. Crossing is a material part of a cheque and the bank cannot afford to disregard it. Crossing is a material part of a cheque and the bank cannot afford to disregard it. Failure to observe crossing will certainly render the bank liable; the payment will be inconsistent with the direction contained in the crossing.

(i) Liability to the true owner

There is no privy i.e., contractual relationship, between the payee or the holder of a cheque and the banker. The true owner is a third party, and hence a banker is not normally responsible to him. The liability towards the true owner arises only where payment has been made by the banker in total disregard of the crossing and thereby the true owner surfers loss. What ever is the loss suffered by the true owner or are the expenses incurred by him will be reimbursed by the banker. The true owner is not defined in law. He is the person who has been entitled to sue upon the instrument as holder in due course and who is entitled to possession of it.

(ii) Liability to the drawer

If payment of a crossed cheque is not in accordance under section 126then the banker is not entailed to debit his customer's account with the amount of such cheque. The paying banker shall lose the statutory protection granted to him under section 128. Such payment is not deemed to be payment in due course.

Check your progress

Fill in the blanks:

1. Crossing first originated in ________________.
2. Crossing means that a cheque should be presented for payment through a ___________________.
3. Where a cheque bears two transverse parallel lines is called ______________.
4. Restrictive crossing includes the words___________________.
5. ____________, ___________and ___________Can only cross a cheque.
6. The paying banker appoints another banker as agent for collection in _________________.

Let us sum up

To ensure safety in transferring money crossing of cheques originated in England. Crossing is an instruction given to the paying banker to pay the amount of the cheques through a bank only. There are three types of crossing namely: general crossing, special crossing and restrictive crossing. General crossing bears two parallel transverse lines with or with out the words 'not negotiable' or 'and company'. Special crossing bears inside the two transverse parallel lines across the face of a cheque the name of the particular bank. Restrictive crossing is also another type of crossing where the words 'account payee' are added between the lines. If the crossing does not bear two transverse lines or does not bear the name of the banker it does not constitute crossing at all.

The drawer, banker and holder are parties who can cross a cheque. When the cheque is handed over to the payee it is said to be issued. The Reserve Bank of India has issued certain directives regarding account payee cheques. If a banker does not have a branch at the place of the paying banker then the cheque may be crossed to another banker who acts as an agent for collection. This is known as double crossing, If the crossing on a cheque is obliterated skillfully the paying banker is not liable if the obliteration is not apparent. A crossed cheque can be opened by the drawer on a later date by canceling the crossing and affixing his full signature. The liability of the paying banker is

clearly define in section 126 of the Negotiable Instrument Act of 1881 on crossed cheques with respect to the true owner and drawer.

Glossary

Crossing : It is an instruction to the paying banker to pay the amount of the cheque through a banker only.

General crossing : Crossing which contains two parallel transverse lines.

Special crossing; In addition to two parallel transverse llines it contains the name of a particular banker.

Restrictive crossing : In between the two parallel transverse lines the words 'account payee only' is added.

Double crossing : A banker to whom it is specially crossed does not have a branch at a place, and then the cheque may be crossed to another banker who acts as an agent for collection.

Obliterating a crossing : Erasing the crossing skillfully by dishonest person is known as obliterating a crossing.

Answer to check your progress

1. England,
2. Bank
3. General crossing
4. Account payee only
5. Drawer, Holder and banker
6. Double crossing

Model Questions

1. Explain the different types of crossing.
2. What does not constitute crossing.
3. Who are partied who can draw a cheque.
4. Explain the salient features of Reserve Bank of India on crossed cheques.
5. Explain the liability of a paying banker.

Unit 13

ENDORSEMENT OF CHEQUES

STRUCTURE

Overview
Learning Objectives
13.1 Definition
13.2 Essentials of valid a endorsement
13.3 Persons entitled to endorse the Negotiable Instrument
13.4 Legal provisions regarding endorsements
13.5 Kinds of endorsements
13.6 Effect of endorsements
13.7 Effect of cancellations of endorsement
13.8 Forms of endorsements
Let us sum up
Glossary
Answers to check your progress
Model questions

OVERVIEW

When the maker and holder of the negotiable instrument sign a negotiable instrument for negotiation at the back of the instrument is known as endorsement. The essentials of a valid endorsement are discussed in this chapter. It is also essential to understand the legal provisions regarding endorsement. Endorsement can be blank or full. There can also be conditional endorsement and restrictive endorsement. The forms of endorsement are different for different types or persons.

LEARNING OBJECTIVES

The objective of this unit is to define and explain endorsements of cheques. This unit appraises:

- Kinds of Endorsements.
- Forms of Endorsements and
- Legal provisions regarding endorsements.

13.1 DEFINITION

"When the maker or holder of a Negotiable Instrument signs the same otherwise than as such maker, for the purpose of negotiation on the back or face thereof or on a slip of paper annexed there to ..... he is said to endorse the same and is called the endorser." Negotiation means transfer of a

Negotiable Instrument by one person to another so as to constitute the transferee as the holder of instrument. "Endorsement" is derived from the Latin in dorsum, meaning 'upon the back' which indicates that the usual place of an endorsement is the back of the instrument. According to section 6 of the Indian Securities Act 1886, an endorsement inscribed elsewhere than on the back of the security itself is not valid. If, as a result of rapid circulation, the back of the instrument is entirely covered by endorsement, the holder, in order to provide space for any endorsement that will not go on the bill itself may tack or paste on it a piece of paper called an Allonge – and subsequent endorsements may be made there on. Allonge then becomes part of the instrument. The following two parties are involved in an endorsement:

Endorser: The person who signs the instrument is called 'endorser'

Indorsee: The person to whom the instrument is transferred by indorsement is called the 'indorsee'.

13.2 ESSENTIALS OF A VALID ENDORSEMENT

★ It should be in ink _ not in pencil and also not by means of rubber stamp.

★ It should be on the back of the instrument. If the back of the instrument is full with endorsement then an allonge is attached thereto.

★ The endorser should endorse the instrument in full and not in part.

★ The endorsement should be made by a person who is the holder of the instrument or the maker of the instrument.

★ In case the instrument is made payable top more than one payee, the endorsement should be made in favour of all the payees whose names appear on the instrument.

★ The spelling of endorsement should agree with the name of the person appearing on the instrument.

★ While making endorsement, the endorser should not add either prefixes or suffixes _ titles such as Sir', 'Pandit' captain etc should not be part of an endorsement. These are called prefixes. Similarly, degrees such as MBA, M.A., Ph.D., etc should not be used while making an endorsement.

★ Endorsement is complete only when the instrument is delivered. The delivery may be either actual or constructive.

13.3 PERSONS ENTITLED TO ENDORSE THE NEGOTIABLE INSTRUMENT

The authorities of persons to endorse the Negotiable Instrument are discussed as follows:

MAKER OR DRAWER: The maker or drawer of the Negotiable Instrument may endorse the same only if he is lawful possession of the instrument of the instrument or is the holder of the same. Thus, the maker or the drawer can endorse it if he holds the instrument in his own name. However, the maker of an instrument may endorse it if he signs it in the capacity of a holder and not as a maker e.g. If a bill is drawn payable to the drawer's order, the first signature of the drawer (as a drawer) is not an endorsement. But if he signs the bill for the second time for the propose of negotiating it, the second signature would be an endorsement.

PAYEE: As a matter of fact, the payee of an instrument is the rightful person to make the first endorsement. However, he may endorse the same only if he is the holder of the instrument. Thereafter, the instrument may be endorsed by any person who has become the holder of the instrument.

ENDORSEE: A person who has become the holder of the negotiable instrument may endorse the same. Thus, an endorsee may also indorse the instrument if he is the holder of the same.

STRANGER: An endorsement cannot be made by a stranger (i.e., a person other than those stated above or who is not a party to the instrument). If a stranger endorses it, the endorsement is void and he cannot be made liable as endorsee.

13.4 LEGAL PROVISIONS REGARDING ENDORSEMENTS

The following provisions are contained in the Act as regards endorsement:

Effect of endorsement: According to section 50 of the Negotiable Instrument Act, the endorsement of a Negotiable Instrument followed by delivery transfers to the endorsee the property therein with the right of further negotiation. Thus the endorser acquires property or interest in the instrument as its holder. Section 50 also permits that an instrument may also be endorsed so as to constitute the endorsee an agent of the endorser.

(i) to endorse the instrument further

or

(ii) to receive its amount for the endorser or for some other specified person.

The examples of such endorsements are as follows:

(a) Pay C for my use.

(b) Pay C or order for the account of B.

Where a negotiable instrument is endorsed for any of the above purposes, the endorsee becomes its holder and property there in is passed on to the endorsee. Endorser: "Every sole maker, drawer, payee or endorsee or all of several joint makers, drawers, payees or endorsees of a negotiable instrument

may endorse and negotiate the same." This is subject to the condition that the right to negotiate has not been restricted or excluded (section 54). Thus in case the instrument is held jointly by a number of persons, endorsement by all of them is essential. The absence of the words "or order" in the instrument or endorsement thereon does not restrict further negotiation. It is essential that the maker or drawer of an instrument must have lawful possession, i.e., holder in order to enable him to endorse or negotiate it. A payee or an endorsee of the instrument must be its holder for the same purpose.

Endorsement for a part of the amount: The instrument must be endorsed for its entire amount. Section 56 provides that "no writing on the negotiable instrument is valid for the purpose of negotiation if such writing purports to transfer only a part of the amount appearing to be due on the instrument". Thus an endorsement for a part of the amount of the instrument is invalid. But in case an instrument has been partly paid, it may be negotiated for the balance of the amount provided a note to that effect is given on the instrument (section 56). If the endorser intends to transfer the document to two or more endorsees separately, it will not constitute valid endorsement.

Deceased person: The legal representative of a deceased person cannot negotiate by delivery only a bill of exchange or a cheque payable to order and endorsed by the deceased but not delivered. (Section 57) If the endorser dies after endorsing the instrument payable to order but without delivering the same to the endorsee, such endorsement shall not be valid and his legal representative cannot complete its negotiation by mere delivery thereof.

Order of endorsement: Unless contrary is proved it presumed under section 118 that "the endorsement appearing upon a negotiable instrument were made in the order in which they appear thereon." It means that the endorsement which appears on an instrument first is presumed to have been made earlier to the second one.

13.5 KINDS OF ENDORSEMENTS

Endorsements are essentially of two kinds – endorsement in blank and in full. Then there are some other kinds as well which are constitutional no doubt, but not very popular.

Endorsement in blank: The mere signature of the endorser on the back of an instrument without mentioning the name of any specified person in whose favour the endorsement is made is said to be an endorsement in blank such an endorsement makes it payable to bearer and consequently, the instrument thus endorsed can be negotiated by mere delivery. It is also called general endorsement. The holder can convert a blank endorsement into a special endorsement by writing above the signature a direction to pay himself or some other person. For example, if a cheque is payable to 'X or order' and X merely

signs on its back, such endorsement is called endorsement in blank. If a cheque is a crossed one, the payment cannot be made at the counter of the bank, even if it is endorsed in blank.

Endorsement in full: If however, the endorser adds a direction to pay the amount specified in the instrument to, or to the order of, a certain person, then the endorsement is said to be in full or special. By inscribing his name on the back of the instrument, the endorser guarantees to his immediate endorsee or a subsequent holder in due course that at the time it left his hands he had a good title to it and that it was genuine in every particular. He also attests thereby, that all the endorsements made prior to this, are genuine. The effect obviously of the full endorsement is that further endorsement can be made only by the endorsee, and it is only the special endorsee or his legal representative who can sue on it. For example: If a cheque payable to Amarjit Singh or order signed by Amarjit Singh with the words "Pay to Jack Pettison or order."; it is endorsement in full. It is only now Jack Pettison who can claim payment. But if Jack transfers it to some other creditor, he will have to make his own endorsement.

Conversion of Blank Endorsement into full Endorsement: According to Section 49 of the Negotiable Instrument Act, the holder of an instrument endorsed in blank, may convert it into an endorsement in full by writing the name of some person (indorsee) above the endorser's signatures. The holder may do so without signing his own name. For example: 'A' was the holder of a bill of exchange. He endorsed it in blank by simply signing his name on the back of it, and delivered it to B. Above A's signature B writes "Pay to C or order". In this case the writing by B will make it endorsement in full from A to C. Here B is not liable as an endorser of the bill because he is not signed it.

Blank endorsement followed by full endorsement: According to section 55 of Negotiable Instrument Act, when an endorsement in blank is followed by an endorsement in full, the endorser in full is liable to his immediate endorsee in full or to any person who claims from such endorsee. He is not liable to any other person. for eg: A cheque is endorsed in blank by X and transferred to Y who endorses it in favour of Z. The latter transfers it without any endorsement to Q. If the cheque is dishonoured Q cannot sue Y or Z but can sue X only.

Conditional Endorsements: If the endorser of a negotiable instrument by express words in the endorsement, makes his liability, or the right of the endorses to receive the amount due thereon, dependent on the happening of a specified event, although such event may never happen, such endorsement is called conditional endorsement **(Section 52)** such an endorser gets the following rights:

★ He may make his liability on the instrument conditional on the happening of a particular event. He will not be liable to the subsequent holder if the specified event does not take place. The endorsee in such a case can sue other parties, to the instrument even before the particular event takes place.

★ He make the right of the endorsee of the instrument conditional on the happening of a particular event, "Pay C if he returns from Bombay." Thus C gets the right to receive payment only on the happening of a particular event, i.e., if he returns from Bombay. If the event does not take place, the endorsee cannot sue any of the parties.

Conditional endorsements do not make the instruments non-transferable. However such endorsements are generally not used.

Restrictive endorsement: It is the endorsement by which the endorsee's right to negotiating the instrument endorsed is restricted or excluded by express words. Sometimes, a restrictive endorsement may merely constitute the endorsee, as an agent, to endorse the instrument or to receive its contents for the endorser, or for some other specified person. For example: if Mr. P.N. Kapur, endorses any negotiable instrument payable as.

(a) "pay the contents to Mr. S. M. Joshi only" or

(b) "Pay Mr. S. M. Joshi for my use" or

(c) Pay Mr. S. M. Joshi for the account of Mr. P. N. Kapur." or.

(d) "the within must be credited to S. M. Joshi"

Mr.Kapur will be restricting the negotiability of the instrument thus endorsed.

The endorser can make restrictive endorsement in any one of the following ways:

(a) He may altogether exclude the right of further negotiation or

(b) He may restrict the right of further negotiation or

(c) He may merely constitute the endorsee as agent to endorse the instrument or to receive its contents for the endorser or for some other specified person.

Sans Recourse Endorsement: Sometimes, the endorser does not want to incur any liability as endorser. In such cases, he may exclude his liability by express words in the endorsement. He can do so by adding certain words such as "sans recourse", "without recourse" etc. such an endorsement is called sans recourse endorsement. For example: 'A' signed the following endorsement on different instruments:

(a) 'Pay B' or order sans recourse'

(b) "Pay B" or order without recourse to me.

(c) "Pay B" or order at his own risk.

These are 'sans recourse' endorsement as 'A' has excluded his own liability. In such cases, if the instrument is dishonoured, the endorsee or the subsequent holder cannot ask the endorser for payment of the same.

Facultative Endorsement: It is an endorsement where the endorser waives some right to which he is entitled. For example, the endorsee is liable to give notice of dishonour to the endorser and normally failure to give this notice will absolve the endorser from his liability. But the endorser may expressly write, "Pay to Y or order. Notice of dishonour waived." By such an endorsement X remains liable for non-payment, even if no notice is served because of his own express surrendering of the right to receive notice.

13.6 EFFECT OF ENDORSEMENT

The effect of endorsement according to Section 50, an unconditional endorsement completed by delivery of the instrument has the following legal effects:

(a) The ownership of the instrument is transformed from the endorser to the endorsee.

(b) The endorsee gets the rights of further negotiation.

(c) The endorsee gets the rights to bring an action for recovery against all the parties whose names appear on the instrument.

13.7 EFFECT OF CANCELLATION OF ENDORSEMENT

According to Section 40 the effect of endorsement is that the endorser whose remedy is impaired, is discharged from liability to the holder who cancels the endorsement. In other words, if a holder of the negotiable instrument cancels any endorsement on it, then he cannot recover the amount from the endorser, whose remedy is impaired against the prior party. For example: 'A' was the holder of a cheque payable to 'B' or order. It conditioned the following endorsement, all in blank:

I. Endorsement by 'B'

II. Endorsement by 'C'

III. Endorsement by 'D'

IV. Endorsement by 'E'

'A' cancelled endorsement by 'C' and 'D' without the consent of 'E' and filed a suit against 'E' for the recovery of the amount due on the cheque. In this case, 'A' cannot recover the amount from 'E' because 'E' remedy against 'C' and 'D' is destroyed by 'A' by canceling the endorsement.

13.8 FORMS OF ENDORSEMENTS

Married Women: If a cheque is payable to a married woman say, to Mrs. Katherina Cecil Jones, the endorsement should be as follows:

(eg) Katherina Jones

(Wife of Mr. Cecil Jones)

If a cheque is payable to a woman in her maiden name, then the endorsement is as follows:

(eg) Ramya Gopal now married to Mr. Suresh. The endorsement is

Ramya Suresh

(nee Ramya Gopal)

nee or formerly (or)

Ramya Gopal

(Now Mrs. Suresh)

Illiterate persons: If a payee of a Negotiable Instrument is an illiterate person, he will endorse by affixing his thumb impression. It should be duly witnessed or attested by reputed people who also give his full address.

(eg) Thumb impression of B

Attested and witnessed by

Mr. Ramu

Advocate

93, Sarojini Street, Chennai.

Partnership Firm: In case of a partnership firm, the name of the firm must be signed by a person (Partner or Manager) who is the authorized signatory, on behalf of the partnership firm. If both the parties sign without indicating that they are partners, then the endorsement is not a regular one.

(eg) (a) For XY Firm

Partner

(a) Per Pro XY Firm X

(b) For or on behalf of XY firm A (Manager)

(d) AGENT

A person may authorize his agent to endorse the cheques on his behalf. The agent will then use the words 'for', 'for and on behalf of ', 'on behalf of', 'per procurationem' or 'per pro' etc., in the endorsement which will indicate that he is signing as the representative of his principal. If the paying banker doubts the competence of an agent then he should make necessary enquiry before making the payment.

(eg) For (or on behalf of or per Pro) Ravi Chandran

Samuel

Agent (or Manager)

Joint Stock Companies and other institutions: (JSCO) In case of JSCO, institution and association, endorsement should be made by persons who are duly authorized to sign on behalf of these institutions. The signatory must give his capacity or official position to indicate his authority to sign the cheques on behalf of his institution

(eg): (i) For National News Agency Ltd.,

R. Sampath

Managing Director

(ii) For Jawaharlal Nehru Memorial College

ABC

Principal

Liquidator: If a company is liquidated and an official receiver is appointed, the latter will sign on behalf of the company as follows:

(eg): For Amar Trading Corporation Ltd., in Liquidation

Ramu

Liquidator

Executor: If an executor is appointed on the death of a person, he will endorse the cheque payable to the deceased as following:

(eg): R.S. Gopal

Executor of the late Manikantan

If two or more executors or administrators are appointed, one of them may endorse as follows:

(eg): For self and co-executor of the late Manikantan

R.S. Gopal

Trustees: If a cheque is payable to the Trustees of the late Manikantan, then both of them will sign as follows:

(eg): R. Gupta   Trustees of the late

S. Guptal   Manikantan

Let us sum up

When a maker or holder signs on the back of a Negotiable Instrument for transfer from one person to another is known as endorsement. A person who signs is the endorser and to whom it is payable is the endorsee. The endorsement should be in ink and in full. Part endorsement is not accepted. The maker and payee can endorse a cheque. The Negotiable Instrument Act lays down various legal provisions with regard to endorsements.

An endorsement may be in blank or in full. There are also other kinds of endorsements like, conditional, restrictive and sans recourse endorsement.

The effect of endorsement is that the ownership is transferred from the endorses to the endorsee. An endorsement may also be cancelled in which case the money cannot be recovered from the endorser. The law also states how endorsement should be followed in case of married women, illiterate persons, Joint Stock Companies, Liquidator, Executors and Trustees.

Glossar

Endorsement : Where the maker or holder of a Negotiable Instrument signs on the back of a Negotiable Instrument for negotiation.

Negotiation : It means transfer of a Negotiable Instrument by one person to another so as to constitute the transferee as the holder of the instrument.

Allonge : If the back of the instrument is entirely covered by endorsement then a piece of paper may be tacked or pasted for further endorsement. This is known as Allonge.

Endorser : The person who makes the endorsement.

Endorsee : The person to whom the endorsement is made.

Sans Recourse : It means without recourse, i.e., the endorser excludes his liability by express words in the endorsement.

Check your progress

1) Define Endorsement.
2) Define Negotiation.
3) What is an Allonge?
4) From where is the word endorsement derived?
5) Give an example for endorsement by an illiterate person.
6) What is Facultative endorsement.

Model Questions

1) Define endorsement and bring out the salient features of a valid endorsement.
2) Explain the different kinds of endorsement.
3) What are the different forms of endorsement?
4) Who are persons who can make an endorsement, what are the legal provisions?

Unit 14

HOLDER AND HOLDER IN DUE COURSE

STRUCTURE

Overview
Learning Objectives
14.1 Definition of holder
14.2 Position of a holder
14.3 Rights of a holder
14.4 Holder of Bearer Cheque
14.5 Definition of holder in due course
14.6 Rights and privileges of a holder in due course
14.7 Comparison between a holder and a holder in due course
14.8 Holder for Value
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

A holder is a person entitled to receive the amount from a negotiable instrument in his own name from the parties thereto. A person who takes a cheque either under a forged or invalid endorsement, cannot be regarded as a holder. A holder in due course means any person who for consideration became the possessor of a promissory note.

LEARNING OBJECTIVES

In this unit, the following concepts are discussed:

- Holder, his position and rights.
- Holder in due course
- Holder for value

The sections mentioned in this chapter relates to Negotiable Instrument Act, 1881.

14.1 DEFINITION OF HOLDER

Holder is defined under Section 8 of the Negotiable Instruments Act 1881 as follows:

"The "holder" of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession there of and to receive or receiver of the amount due thereon from the parties thereto." "Where the note, bill or cheque in lost or destroyed, its holder is the person so entitled at the time of such loss or destruction."

Thus holder means any person entitled in his own name to the possession of a negotiable instrument and to recover or receive the amount due thereon from the parties. A holder must therefore have the possession of the instrument and also a right to recover the money in his own name.

The analysis of Section 8 reveals that a person becomes a holder of the Negotiable instrument if the following conditions are satisfied:

- ★ He must be entitled in his own name, to the possession of the instrument; and
- ★ He must also be entitled in his own name to receive or recover the amount due on the instrument.

The "payee", "bearer" and the "endorsee" of the negotiable instruments are entitled to the instrument in their own name, and thus are the holder of the same. For e.g. if a person acquires a cheque or bill by theft, fraud or forged endorsement or finds it lying somewhere, he does not acquire in his own name legal title thereto and hence he cannot be called its holder. The holder is competent to receive payment or recover the amount by filing a suit in his own name against other parties, to negotiate the instrument and to give a valid discharge. Transfer of negotiable instrument is known as "negotiation" and it takes place in 2 ways namely:

a) By mere delivery and

b) By endorsement and delivery.

An agent holding an instrument for his principal will not be a holder of it, although he may receive its payment. Only a holder can bring a legal action to recover the amount due on the instrument. In case a negotiable instrument is lost or destroyed, its holder is the person, who was entitled to the instrument, in his own name, at the time of such loss or destruction.

14.2 POSITION OF A HOLDER

- ★ The term holder as defined does not include a person, who through in possession of the instrument does not have the right to recover the amount there on from the parties, such as the finder of a lost instrument.
- ★ No person can sue on a negotiable instrument, unless he is named therein as a payee, or unless he gets his title as an endorsee or bearer.
- ★ The title of the person claiming as holder must be required lawfully.

14.3 RIGHTS OF A HOLDER

- ★ An endorsement in blank may be converted by him into endorsement in full.
- ★ He is entitled to cross a cheque either generally or specially and also with the words "Not Negotiable"
- ★ He can negotiate a cheque to a third person, if such negotiation is not prohibited by the direction given in the cheque.
- ★ He can claim payment of the instrument and can sue in his own name on the instrument.
- ★ A duplicate copy of a lost cheque may be obtained by a holder.

14.4 HOLDER OF BEARER CHEQUE

In India banks ordinarily require the persons presenting bearer cheques for payment to endorse them. Although not legally bound to do so, the holder of a bearer cheque generally raises no objection, probably because, if he refuses to sign, the paying banker may insist upon having a properly stamped receipt for the amount paid to him. The paying banker can have no justification for asking for the identification of the holder of a bearer cheque, although in case of doubt, especially when the cheque presented for payment across the counter is for a larger amount, the banker may if possible, ask on the telephone, for the drawers' confirmation. In case of bearer cheques made payable to corporation presented for payment without any endorsement, the payment banker would be well advised to make inquiries before paying them at the counter. Even cheques are drawn by limited companies in favour of selves and presented at the counter for encashment without any endorsement it is advisable to make such inquiries.

14.5 DEFINITION OF HOLDER IN DUE COURSE

A holder in due course means a holder who takes the instrument in good faith for value before it is overdue and without any notice of defect in the title of the person who transferred it to him. Section 9 of the Negotiable Instruments Act defines Holder in Due Course as under:

"Holder in Due Course means any person who for consideration become – the possessor of a promissory note, bill of exchange or cheque, if payable to the bearer, or the payee or indorsee thereof if payable to order, before the amount mentioned in it becomes payable and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title." Thus, a holder in due course is a person who takes the possession of Negotiable Instrument in good faith for consideration, before its maturity. The following conditions need to be satisfied to become a holder in due course:

- ★ He must be the holder of the Negotiable Instrument. In case of bearer instrument, he must be the possession; and in case of an order instrument he must be the payee or endorsee.
- ★ He must have obtained the Negotiable Instrument before its maturity, i.e. before the amount mentioned in the instrument becomes payable.
- ★ He must have obtained the Negotiable Instrument for valuable consideration. A person, who takes the instrument without consideration, does not become a holder in due course. In case of Negotiable Instrument, however, the consideration is always presumed to have been given.
- ★ He must have obtained the Negotiable Instrument in good faith, i.e., honestly. This means that at the time of taking the instrument, the holder should not have any 'cause to believe' that there is something wrong. The term 'cause to believe' means a suspicion in one's mind about some illegality affecting the instrument. As a matter of fact, two things are expected from the holder namely (a) he must act honestly and (b) he must make reasonable inquiries in case of doubt in the title of the transferor.
- ★ He must take the Negotiable Instrument which is complete and regular on the face of it. If a Negotiable Instrument is incomplete, e.g.: blank, undated, not properly stamped, without drawer's name, then the holder will not become the holder in due course of such instrument. The term 'face' for this purpose includes back of the instrument also,

If all the above requirements are satisfied the holder of the Negotiable Instrument becomes its "holder in due course". As a matter of fact, he becomes the owner of the instrument irrespective of any defects in the title of the person from whom he received the instrument and holder in due course can recover the amount of the instrument from all previous parties even if there were some defects in cash or transaction. It will be interesting to note that once the instrument passes through the hands of a holder in due course, it becomes free from all defects.

14.6 RIGHTS AND PRIVILEGES OF A HOLDER IN DUE COURSE

The holder in due course enjoys special rights and privileges as listed below:

Right in case of in Choate stamped instrument: The term "in choate instrument" may be defined as an incomplete instrument. If a Negotiable Instrument was original in Choate instrument and a subsequent transferor completed the instrument for a sum greater than what was the Intention of the maker, the right of a holder in due course to recover the money of the Instrument is not at all affected. The transferee can recover the full amount of the

instrument from the drawer or maker (i.e., who signs and delivers the instrument) only the following conditions are satisfied under section 20 of Negotiable Instrument Act 1881.

- ★ If he is the holder in due course of the instrument, and
- ★ If the amount filled is sufficiently covered by the stamp on the instrument.

For example: Ram signed his name on a bank stamped paper and delivered the same to Gopal with an authority to fill it up as a promissory note for Rs. 2000/-. But Gopal fraudulently filled in Rs. 5000/- and endorsed it to Shyam. Who is the holder in due course? In this case Shyam is entitled to recover Rs. 5000 from Ram. Ram cannot escape his liability on the ground that in filling the amount, his authority has been exceeded by Gopal. However if the amount filled is not sufficiently covered by the stamp on the instrument then the holder in due course can recover only that amount which is covered by the stamp.

Rights on fictitious bills: We know that a "fictitious bills" is a kind of a Bill of Exchange payable to a fictitious person i.e., a bill of exchange where payee is fictitious. The fictitious payee means that the payee who is not in existence, or if in existence he is never intended by the drawer to have the payment. If a bill of exchange is drawn on behalf of a fictitious person and is payable to his order, the acceptor is not relieved of his liability to holder in due course because of search fictitious name. But it is essential that the holder in due course prove that the document bears the endorsement with signature in the same hand as that of the drawer and purporting to be made by the drawer (Section 42). For example: X draws a bill on Y but signs in the fictitious name of Z and is duly accepted by Y. X endorses it to A, who becomes its holder in due course Y, the acceptor of the bill, cannot deny his liability on the bill to the holder in due course on the ground that it was drawn on behalf of a fictitious person Z. It is however, essential that the signatures of Z as drawer, and as endorser, must be in the same handwriting.

Rights in case of Prior Defects in the instrument: A holder in due course gets a title to the negotiable instrument free from all the defects in the title of the prior parties. And he can recover the amount of the instrument irrespective of any defect in the title of the prior parties i.e. the rights of a holder in due on the instrument are not affected even if there were some prior defects in the instruments (Section 58). Thus, when any Negotiable Instrument is lost or obtained by means of an offence or fraud or for an unlawful consideration, no other person except a holder in due course is entitled to receive the amount due on it. For example: A obtained by fraud a promissory note for Rs.5,000 from B and endorsed the same to C who received it in good faith and for

value. In this case C is the holder in due course and he can recover the amount from B and B cannot avoid his liability on the ground that the promissory note was obtained by A from him by fraud.

Right against the prior parties: A holder in due course has a right to recover the amount due on the instrument from anyone of the parties prior to himself As a matter of fact, every prior party is liable to make payment to the holder in due course until the instrument is duly satisfied i.e. the payment due on the instrument is duly made (Section 36). Thus, the holder in due course can file a suit, in his own name for recovery of the amount due on the liable on the instrument. The term "prior parties" includes the maker and acceptor of the instrument and all the intervening indorses.

Right in case of conditional delivery of instrument: Sometimes a Negotiable Instrument is delivered to a person; upon some condition i.e. it will be effective on the happening of a certain event. In such cases the Negotiable Instrument cannot be further negotiated unless such event happens. And if transferred before the event the transferee will not get a good title to the instrument. However if it is transferred to a holder in due course his rights will not be affected by such condition (Section 47). In other words the rights of a holder in due course are not affected even if the instrument was originally delivered on some condition. The rights of a holder in due course are not affected and the parties liable for payment cannot avoid. Their liability cannot be escaped on the ground that the delivery of the instrument was conditional. For example: A made a promissory note for Rs.4500 payable to Z and delivered it to Z on the condition that Z endorsed it to D a holder in due course. D can recover the money from A, who cannot refuse payment on the ground that death of Y has not happened.

If a Negotiable Instrument, (example for discounting only) the holder in due course can recover the amount due course can recover the amount due on the instrument even though the special purpose is not fulfilled.

Title free from all defects: Section 53 states that "the holder of a Negotiable Instrument who derives title from a holder in due course". This is the greatest privilege of a holder in due course. He always possesses better title than that of his transfer or any of the precious parties and can give to the subsequent parties the good title that he possessor. It may be noted that once the instrument passes through the hands of a holder in due course, it is purged (i.e. cured) of all prior defects. For example: A had a bill of exchange for Rs.1800 drawn upon B the drawer by fraud. A endorsed it to C who took it in good faith. C endorsed and delivered the same to D. When the Bill of Exchange passed through C's hands who is the holder in due course it because free from all defects and hence D gets a good title the Negotiable Instrument provided D is not a party is the fraud committed by A.

- ★ Every holder of a Negotiable Instrument is presumed to be a holder in due course a holder need prove this. However this presumption is reputable i.e. challenged by the party liable to pay.
- ★ Section 120 provides that " no maker of a promissory note and no drawer of a bill of exchange or cheque and no acceptor of a bill of exchange for the honour of the drawer shall in a suit there on by holder in due course, be permitted to deny the validity of the instrument as originally made or drawn." For example: Gopi is the maker of a promissory note for Rs2000 payable to Ram who endorses it to Ravi for valuable consideration. On its due date it is dishonoured. Ravi files a suit for the recovery of the amount. Gopi cannot deny that the instrument drawn by him was not valid one.
- ★ No maker of a promissory note and no acceptor can escape then liability on the ground that the payee had no capacity (i.e. not competent) to indorse the promissory note or the bill of exchange that the acceptor is estopped (i.e. prevented) from denying payee's capacity to endorse the instrument (Section 121).
- ★ Sometimes, the holder in due course files a suit, for the recovery of the amount due on the instrument against the endorser. In that the signatures of any prior party were forged or the he (i.e. prior party) was not competent to contract i.e. the endorser is estopped (i.e. prevented) from denying the signatures or capacity to contract of any prior to the instrument (Section121).

For example: X draws a bill of exchange on Y in favour of Z who endorses the same to A, a minor. A endorses it to B and B to C who becomes its holder in due course. It is dishonoured, C can file a suit against all parties except A the minor. B cannot plead that being a minor A's cannot endorse the bill. Hence the bill is void. B will be liable to C on the bill.

14.7 COMPARISON BETWEEN A HOLDER AND HOLDER IN DUE COURSE

- ★ A holder means any person entitled in his own name to the possession of the instrument and to recover or receive the amount due thereon from the parties.

A holder in due course means a holder who has taken the instrument in good faith and for value and also before its maturity.

- ★ An instrument can be given as a gift to the holder, i.e., without any consideration. A holder in due course receives the instrument only for a consideration.

- ★ A holder does not get a good title if the title of any prior party is defective. A holder in due course gets a title free from any defect.
- ★ A holder may acquire the instrument even after maturity. A holder in due course must acquire the instrument before it has become due for payment, i.e, before maturity.
- ★ A holder of an instrument can recover the amount from a person who has signed it and also from the transferor from whom he has obtained it not from other parties. A holder in due course can enforce his rights against all the prior parties until the instrument is duly discharged.
- ★ A holder does not enjoy any special privileges. A holder in due course enjoys special privileges.

14.8 HOLDER FOR VALUE

This is not defined in the Negotiable Instrument Act. In England, according to the Bill of Exchange Act, where value of a bill has at any time been given, its holder is termed to be a holder for value as regards the acceptor and all parties to the bill who became parties prior to such time. The person who claims himself as the holder for value need not have given any value for the instrument.

Check your progress

State True or False

a) A holder in due course takes the instrument in good faith for value (True/False)

b) A holder in due course takes the instrument after it is overdue. (True/False)

c) The term inchoate instrument means complete instrument (True/False)

d) Fictitious bills are a kind of Bills of exchange where payee is fictitious. (True/False)

e) When any Negotiable Instrument is lost or obtained by means of an offence or fraud or for an unlawful consideration, no other person except a holder in due course is entitled to receive the amount due on it. (True/False)

Fill in the blank:

(i) A payee entitled in his own name to the possession of a Negotiable Instrument is called a ______________.

(ii) Transfer of Negotiable Instrument is known as ______________.

(iii) An ____________ in blank may be converted by him into endorsement in full.

(iv) A holder has the right to obtain a duplicate copy of a ___________.

(v) The paying banker is not justified in asking for the__________of the holder of a bearer cheque.

Let us sum up

A holder is a person who has possession of the instrument and also a right to receive money in his own name. A holder can transfer the instrument and give a valid discharge. He is a payee named in the instrument who has a legal claim. In India paying bearer banker requires the holder of bearer cheque to endorse them. A holder in due course takes the Negotiable Instrument in good faith for consideration before the due date. He should be the holder of the instrument and should not have any specimen that something is wrong. A holder in due course enjoys many privileges. A holder in due course possess better title than that of his transferor or any of the previous parties and give a good title to subsequent parties.

Though not defined in the Negotiable Instrument Act a holder for value is defined in England. A holder of a bill where value of a bill is given is deemed to be holder for value.

Glossary

Holder : Defined in Section 8 means any person entitled in his own name to the possession of a Negotiable Instrument and to recover or receive the amount due thereon from the parties.

Negotiation : Transfer of Negotiable Instrument is known as negotiation.

Holder In Due Course : A holder in due course means a holder who takes the instrument in good faith for value before it is overdue and without any notice of defect in the title of the person who transferred it to him.

Inchoate instrument : It is defined as an incomplete instrument.

Fictions Bills : It is a kind of bill of exchange which is payable to a fictitious person.

Holder for Value : Where value of a bill has at any time been given, its holder is deemed to be a holder for value as regards the acceptor and all parties to the bill who became parties prior to such time.

Answers to check your progress

State true or false:

1. True 2. False 3. False 4. True 5. True

Fill in the Blank:

1. Holder 2. Negotiation 3. Endorsement

4. Lost cheque 5. Identification

Model Questions

1. Define the term 'holder' and 'holder in due course and the Negotiable Instrument Act.
2. What are the rights and privileges of holder in due course.
3. Enumerate the differences between a Holder and a Holder in Due Course.
4. Write a short note on holder for value.

Unit 15

PAYMENT OF CHEQUES

STRUCTURE

Overview

Learning Objectives

15.1 Precautions to be taken by the paying banker

15.1.1 Proper form of the Cheque

15.1.2 Types of Cheque

15.1.3 Sufficient balance and payment order

15.1.4 Material Alternations

15.1.5 Banking days and hours

15.1.6 Forgery of drawer's signature

15.2 Statutory protection to the paying banker

15.3 When the banker can refuse payment

15.4 Banker's replies to dishonored cheques

15.5 Bouncing of cheque an offence

Let us sum up

Glossary

Answers to check your progress

Model Questions

OVERVIEW

In the earlier unit of block IV we have studied about cheques, crossing and endorsement. In this unit the statutory obligations of the paying banker are discussed. The sections numbers mentioned in this chapter refers to Negotiable Instrument Act of 1881.

LEARNING OBJECTIVES

The rights of the paying banker are presented in this unit:

- Precautions to be taken by the paying banker
- Statutory protection to the protection banker
- When the banker can refuse payment
- Banker's replies to dishonored cheques
- Bouncing of cheque an offence
- Payment in due course

Amongst the negotiable instruments, cheques are undoubtedly the most popular document. With the growth of banking habit, there has been an astronomical increase in the issue and circulation of cheques. Efforts have

certainly been made to supersede the cheque by some other convenient device, but it continues and perhaps will continue to be the principal method of the repayment of the customer's indebtedness. A cheque no doubt is a negotiable instrument, but more important, it is mandate of the customer which the banker is under statutory obligations to carry out. It is written order by which the customer requires his banker (drawee) to refund the money lent out to him in the form of deposits. The refund may be made either to the drawer (customer) himself of to some third party (payee), and it is this repayment to third parties which has given rise to important and difficult legal problems. Bouncing of cheques is one such problem. It is suggested that the issuance of bad cheques should be a cognizable offence.

Where a cheque is drawn, the banker has an obligation to pay because the customer has opened an account and, presumably, has an adequate credit balance. Thus a cheque has, a dual function:

i) it gives rise to the banker's obligation to pay any money to the debit of his customer, and

ii) it is a type of bill of exchange which in the absence of specific stipulations is not only transferable, but may also be fully negotiable.

That is why a statutory responsibility has been cast upon a bank in terms of section 31 of Negotiable Instrument Act of 1881, when it states "The drawee of a cheque, having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment must compensate to the drawer for any loss or damage by such default."

The cardinal doctrine is that cheques should not be dishonored except for valid reasons, carefully avoiding any damage to the credit of the customer. At the same time, he should not meet every demand by third parties, whether for money clamed from the customer's affairs. In both the cases if he acts wrongly, he will have to compensate his customer.

15.1 PRECAUTIONS TO BE TAKEN BY THE PAYING BANKER

The paying banker paying banker should take the following precautions while making payment of his customer's cheques.

15.1.1 Proper Form of the Cheque

The Negotiable Instruments Act defines a cheque but does not prescribe its form. Nor does it require that a cheque should be drawn on the printed form issued by the bank. The banker should, therefore, not dishonor a cheque drawn on a piece of paper provided it carries an unconditional order to the banker and fulfils other requisites of a cheque. But almost every bank in India

requires that cheques must be drawn on the bank's printed forms' and 'the bank reserves its right to refuse payment of any cheques drawn otherwise'. This makes it essential that the cheque forms issued by the banker must be used by the customers. The advantages of using printed forms are as follows:

i) It is convenient for the drawer to draw a cheque.

ii) The counterfoils of the cheques serve the purpose of record for future reference.

iii) If the drawer wishes to countermand payment of any cheque, he can issue instructions to the banker more conveniently and with certainly as every cheque form is serially numbered and can be easily identified by the banker.

iv) If the customer keeps the cheque book safely and carefully, chances of forgery can be minimized.

A cheque must bear a date because the mandate of the customer to the banker given in the cheque becomes legally effective on the date mentioned therein. The drawer of a cheque fills in the date before the cheque is issued, but if he has not done so, the instrument does not invalid. The payee of the cheque or any subsequent holder thereto may fill in the date. But if an undated cheque is presented for payment, the banker must refuse payment.

The date should not be incomplete i.e., it must include beside the year, the name of the moth and number of the day. For example, a cheque bearing "January 1998" or "November 26, 19...." not a complete dated cheque and banker must re fuse its payment. If a cheque is dated "April 31,1997, it should b e paid if it is presented on April 30 or thereafter.

15.1.2 Types of cheque

(a) Stale cheque

If the drawer mentions a date earlier to the date of writing the cheque, it is called an ante-dated cheque. In India a cheque is treated as stale cheque after the expiry of six months from the date of the cheque and the banker returns slush cheque to get the drawer's confirmation.

(b) Post-dated cheque

If the drawer or the holder mentions a date on the cheque, which as subsequent to the date on which lit is drawn, it is called a post-dated cheque.

For example: a cheque drawn on 1st April 2000 bears the date of 10th April, 2000, it is a post dated cheque. Post dated cheque is valid but become effective only on the date mentioned therein. If a banker pays a post-dated cheque his liability are as follows:

a) Such payment is deemed as payment made without the authority of the drawer.

b) If as a consequence of payment of a post-dated cheque by the bank, any other cheque is dishonored on the ground of insufficiency of funds, the drawer will be entitled to claim damages for its dishonor under section 31.

c) If the customer dies, becomes insolvent or insane after the banker has made the payment but before the date mentioned in the cheque, the amount cannot be debited to the customer's account because the latter's mandate becomes ineffective on the occurrence of any of these events.

d) Payment of a post-dated cheque before the date of the cheque is not considered as payment in due course, hence the banker cannot avail statutory protection.

(c) Mutilated Cheques

It is a cheque which has been torn into two or more pieces, but pasted afterwards. Whether such a cheque should be paid or not will depend upon the available evidence, the surrounding circumstances and the extent of legibility of material facts. If a cheque is accidentally torn in the hands of the payee before presentation, the banker can pay it after obtaining confirmation from the drawer or else getting the collecting bank's guarantee. If nonce is available, the drawee banker should return it with the remark "Mutilated cheque", or "Cheque torn". If however, the banker has proof enough the drawer wanted to cancel a particular cheque by tearing it into pieces, he has no recourse open, but to return it. Likewise, if the main contents of the cheque are so erased or concealed the banker cannot make out the name of the payee, the amount, etc., he is justified in refusing payment. In case, where a cheque is not exactly torn into two, but is mutilated in some corner, the banker can exercise his discretion.

15.1.3 Sufficient balance and payment order

Amount of the cheque

The amount of the cheque must be a sum certain and on the face of the instrument it should be stated both in words and in figures. In case the two amounts differ then the banker has to pay the amount stated in words (section 18).

However, where the amount is stated only in words the cheque must be paid, lest he is held responsible for the wrongful dishonor and hence liable for any loss or any damage which is so occasioned to the customer. It is worthy to note that where the amount is stated only in figures, the banker can safely return the cheque without incurring any liability whatsoever.

Sufficient balance

Despite the correctness of the amount the question of payment of cheque arises only when the balance to the credit of the customer is sufficient. Unless arrangements have been made beforehand for overdrawing the amount, the banker is under no obligations to honor the cheque with inadequate funds in the account of the drawer. This is important because a cheque has to be paid in full and never in part. If the drawer through oversight honors a cheque when the customer maintains insufficient balance, he may lose money through failure to realize it from the customer.

It may be noted that while computing the balance available for drawing by the customer , the amount shall be taken of the unclear items. If the customer relying thon instrument deposited by him draws cheque and which have not yet been cleared, the banker is entitled to return them with the remarks, "Effects not cleared." Further, the amount available for drawing is the amount to the credit of the customer at the drawee-branch, and not of other branches even of the same bank.

Payment is made in Chronological order of receipt

In case of a current account, any number of cheques may be presented for payment on a single day. The banker generally follows the rules of making payment of the cheques in the chronological order of their receipt. It means that the cheque first received by the banker on an account will be paid first, and so on. The serial number of the cheque or the date of issue is not significant for this purpose. In case two or more cheques are presented simultaneously and if there are insufficient funds to honor all cheques then a cheque for a bigger amount is paid first. If both cheques are for equal amount then the banker can honor any cheque first.

15.1.4 Material Alterations

A cheque contains a mandate of the drawer to his banker to pay a specified sum of money to the bearer of the person mentioned therein or to his order. Any alterations or correction therein, to be valid, must be made by, or with the consent of, the drawer and confirmed by his full signature. The paying banker should be careful in this regard and should not make payment id the cheque bear an alteration, specifically a material alteration, without confirmation by the drawer.

An alteration is considered as material alteration if it effects the operation of the instrument subsequently and the liability of the parties concerned is changed significantly. Examples of material are as follows:

i) Alteration of the date of the cheque

ii) Alteration of the place of payment

iii) Alteration of amount of the cheque

iv) Alteration in the names of the parties or the relationship between them of affecting g their legal status

v) The substitution of the word "bearer" in place of "order" in the cheque

vi) An alteration of the crossing of the cheque

Legal effects of material alteration

A material alteration on a negotiable instrument shall have the following effects:

i) The instrument becomes a void one as against all persons who were the parties to the instrument at the time the alteration was made and who did not give their consent for such alteration.

ii) A material alteration made with consent of the parties to the instrument shall not become a void one.

iii) An alteration, though material, will not vitiate the instrument if:

★ It is made before it is issued to the other party,

★ It is made merely for the purpose of correcting a minor mistake &

★ It is made to carryout the common intentions of the original parties to the instrument.

The burden of proof of material alteration falls on the person who seeks to enforce the negotiable instrument.

15.1.5 Banking days and hours

The days and hours for the payment are also stipulated by the banker.

Section 65 lays down that a cheque must be presented to the paying banker for payment within the banking hours. Banking hours mean the fixed period of time when a bank transact the banking business with the public notified by a general notice. The banker should make payment of the cheque presented to him during the banking hours only. Different working hours may be fixed by different banks or by the same bank in different cities or localities to suit the local people.

If a banker pays cheque presented after banker hours, he incurs a grave risk. It is quite possible that a customer a may countermand the very cheque the next morning the banker honored earlier after the banking hours. If the date of the cheque is a pubic holiday, then the instrument is deemed to be due on the next business day.

15.1.6 Forgery of drawer's signature

The paying banker should carefully ascertain that the cheque bears the genuine signature of the drawer after comparing the same with his specimen signature.

The drawer must sign the cheque on its face and not on the back of the cheque. The account holder may change his specimen signature at any time and supply the same to the banker. The banker is bound to accept the new specimen signature from a specified date. If the signature on a cheque differs from the specimen signature or the banker feels that the signature is a forged one, the banker can refuse payment. The paying banker is not given any protection if he pays a cheque bearing a forged signature. The payment of the cheque is deemed to as made the moment money is physically handed over by the cashier to the presenter of cheque.

Check your progress – I

Fill in the blanks:

1. If a cheque has been torn into two or more pieces it is called ______________.
2. Presentment of payment of cheques should be made to a paying banker during ______________.
3. A ______________ cheque cannot be presented for payment before the date arrives.

15.2 STATUTORY PROTECTION TO THE PAYING BANKER

Payment of cheques involves risk to the paying banker because the latter's duty is to pay the amount of the cheque to the right person according to the instructions of the customers. The banker has to honor his customer's cheque on demand and hence he cannot make detailed enquiries about the title of the person who presents the cheque for payment. The Negotiable Instrument Act provides the banker protection at certain situations:

Protection in case of order cheques

Section 85 provides statutory protection to the paying banker as follows:

"Where as cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course."

This section particularly seeks to provide protection to the paying banker in case of forged endorsement. Although the above quoted section speaks of endorsements only by the payee, yet it does cover other endorsements too. The main object of this section is "to make the banker free of all responsibilities in respect of the genuineness of the validity of the endorsement purporting to be that of the payee or his authorized agent". Two conditions should be fulfilled to avail such protection, they are:

(a) Regular Endorsements

It is essential that the endorsements are regular though not necessarily genuine or valid. If a cheque is payable to a certain person is endorsed under

the signature bearing the same name and in the same spelling as that of the payee of the endorsee, the endorsement is said to be regular. A valid endorsement is that endorsements which has been made by the person who is the true owner of the cheque or has the necessary authority to sign on behalf of the payee. To avail the statutory protection, the banker must ascertain that the endorsement is regular; he need not check its validity. The banker need not concern himself with the identification of the person who signs the cheque as the endorser. When "Ashok Jain "signs as "Ashok Jain" in the same spelling it is considered as the regular endorsement. If a cheque is payable to X & Y jointly then both of them have to endorse the cheque

(b) Payment must be made in Due course

According the section 10 defines a payment in due course as payment in accordance with the apparent tenor of the instrument in good faith and without negligence any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned therein. The essential features of a payment in due course are as follows:

1) The payment should be made in accordance with the apparent tenor of the instrument.
2) The payment should be made in good faith and without negligence.
3) Payment must be made to the person in possession of the instrument in circumstances which do not arouse suspicion about his title to possess the instrument and to receive payment thereof.
4) payment must be made in the ordinary curse of business, i.e., according to current banking practice and within n normal banking hours.

(c) Effect of statutory protection

The important point not to be missed here is that the statutory protection is granted in respect of the forged signatures of the payee or the endorser, and not of the drawer. If the drawer's signature is falsely made on a cheque, the instrument becomes totally imperative and passes on title to the transferee.

A person to whom money has been paid or anything delivered by mistake or under coercion must repay it. But this rule is qualified by the *doctrine of equity*. The doctrine of equity disfavor unjust enrichment. If a payee has not been enriched unjustly, he cannot be required to repay. In other words, if the position of the payee has not been altered to his detriment, he must repay the money to the payer. If the position of the payee has been changed to his prejudice. and thereafter the mistake has been detected, he cannot be held liable.

Protection in Bearer cheques

A Banker who in good faith and without negligence pays a bearer cheque to the person, who presents it, is discharged from all liability and can debit his customers. An uncrossed bearer cheque is an open cheque and can be pad to the person in possession without any liability on the part of the banker so long as he pays it in the ordinary course and with due care. Even if the holder had no property in the cheque or had a defective title, e.g., when some thief stole the cheque or found it after it was lost, the banker cannot be held responsible for loss to the true owner unless he has been negligent. Section 85(2) provides protection to the paying banker in respect of bearer cheques as follows:

"Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof notwithstanding any endorsement whether in full or in blank appearing thereon, and notwithstanding that any such endorsement purports to restricts or exclude further negotiation"

Thus the bank will be relieved from liability if it pays the amount of the cheque to the nearer who presents it provided there was nothing irregular in the instrument or suspicious about the presenter. But a payment before the due date or the payment of a cancelled cheque in circumstances such as to excite suspicious cannot be regarded as payment in due course and the bank will remain liable for the amount of the cheque to the customer even after such payment. If apparently there is nothing to arouse his suspicion the banker need not ask for the presenter's endorsement in an open cheque, though in practice banks do insist on the presenter signing on the back of the cheque probably for the purpose of identifying the person who receives payment.

Protection in case of crossed cheques

The whole purpose of crossing is to prevent anyone but the payee from encashing a cheque. The drawee banks must not pay it except through another bank in the case of general crossing and the prescribed bank where the crossing is special. If the banker ignores the directions conveyed by the type of crossing while paying, he cannot debit the customer's account with the amount of the cheque and will otherwise be held liable for any loss which the true owner sustains as a result of this payment. If the banker makes the payment as per the crossing he I protected under section 128 which lays down

"Where the 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 hand 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 entitled to and placed in if the amount of the cheque had been paid to and received by the true owner thereof". Thus the banker has to fulfill the following two requirements:

1. He has made payment in due course in good faith and without negligence according to the apparent tenor of the cheque.
2. The payment has been made in accordance with the requirement of the crossing.

The paying banker is discharged from his obligations on a crossed cheque irrespective of the fact that the payment was received by the collecting banker on behalf of a person other than its true owner. Where as the paying banker shall not get protection if the payment on a crossed cheque was made when there was irregular endorsement or a material alteration or a forged signature of the drawer.

15.3 WHEN THE BANKER CAN REFUSE PAYMENT

The banker must refuse payment of the cheques without incurring any liability in the following circumstances:

1. When the drawer countermands payment

A cheque is an unconditional order of the drawer to the banker. The drawer is competent to cancel or withdraw such order at any time before the payment is made. The following points may be noted in this connection:

(i) The right to countermand payment of a cheque is vested in its drawer and not the payee or the endorsee, as there is no contractual obligation on the banker towards the payee of the holder.

(ii) The stop payment order may be given by the drawer verbally of in writing; a telephonic message is also valid, if the banker can identify the voice of the customer.

(iii) The order to stop payment must be signed by the drawer of the cheque. In case of firm, joint account, or a joint stock company any of the persons authorized to sign may stop payment.

(iv) The drawer must inform the banker full and correct details of the cheque, payment of which is intended to be stopped, i.e., the number of the cheque, name of the payee and its amount.

(v) To be binding on the banker the countermand order must be duly served on the banker before the payment of the cheque is made. The time of receipt of such order is very important. It must be received by the banker before he actually makes payment of the cheque.

(vi) The banker shall be liable to the drawer if he pays the cheque even if by oversight after the receipt of countermand order. If the banker made the

payment of the cheque after the banking hours on any working day or before the banking hours on the next working day and in the meanwhile the customer countermands such payment, the banker shall be liable for the same.

(vi) The stop payment order remains effective until it is revoked by the drawer or there is an agreement limiting its period.

(vii) If the banker pays a cheque stopped by the drawer, he cannot recover the amount from a person who becomes it bona fide holder, because his right to recover the money from the drawer of the cheque cannot be affected by the negligence of the paying banker.

2. Death of the drawer

On receipt of reliable information about the death of the customer, the banker must stop payment of the cheque signed by him because the order if the customer t the banker ceases to operate on the occurrence of his death. The following points must be observed:

(i) The time of receipt of notice or information by the banker about the death of the customer and not the time of death itself is important for the banker.

(ii) Banker should not real on rumors and must ascertain the new about customer's death reliably.

(iii) If an agent, who has signed a cheque on behalf of this principal, dies the payment of such cheque is not to be stopped because the agent himself is not the drawer.

(iv) The account of the deceased customer shall remain inoperative until a succession certificate is produced by his legal representative or a probate of the will or a Letter of Administration is received.

3. Insolvency of the Drawer

If a debtor commits an act of insolvency as defined in the insolvency law, either he or any of his creditors may present in the Court of Law for and order adjudication. On the customer being adjudicated as insolvent all his properties including the banks accounts of the customer is vested with the official assignee of receiver. The banker must stop payment from customer's account as soon as he receives the information that an insolvency petition has been filed by or against the customer. After an order of adjudication has been issued, the banker must close the account and communicate to the Official Receiver the balance to the creditor of the customer. If the customer's account shows a debit balance and the banker receives money from or on account of the customer, before the receipt of a notice regarding the filing of an insolvency petition against the customer, the banker can justifiably credit the money to the account of the customer with effect that the debit balance. But the money

received after the notice of insolvency petition cannot be appropriated in such a way and the same shall belong to the Official Receiver.

If a partner is adjudicated insolvent he cannot operate the firm's account and his estate shall not be liable for the debt incurred by the firm after the date of the insolvency. The solvency partners may however continue to operate the firm's account in order to wind up the business of the firm. If a cheque signed by the insolvent partner is presented for payment, the banker should get the confirmation of the solvent partners.

In case one of the joint account holders is adjudicated as insolvent, the banker must stop payment from the joint account, because the balances is to be apportioned between the solvent account-holder and Official Receiver of the insolvent one. The banker's authority to pay cheques should be stopped on making of a winding up petition in case of a company customer.

4. Insanity of the customer

A banker is also entitled to refuse payment if he learns of the customer's lunacy or other mental incapacity. It, however, goes without saying that cheques issued during his lucid interval i.e., when he could reasonably understand the implications of his actions are not to be dishonored. The banker should not refuse payment simply on hearsay or rumours of the customer's insanity. He must tap reliable sources to confirm the news of his customer's mental disorder.

5. Notice of assignment of credit balance

The credit balance in the account of a customer may be assigned or transferred by him to another person under Section 130 of the Transfer of Property Act 1882. On receipt of a notice of such assignment, the banker must stop payment of the cheque drawn by the assignor as the latter ceases to be the owner of the funds.

6. Garnishee order

A banker is bound to comply with the order issued by the court restraining him from paying the money from a customer's account. He must refuse payment of the cheque presented after the receipt of a Garnishee Order attaching the customer's money.

7. Breach of trust

If the banker comes to know that the customer, who is operating a Trust account, contemplates to use the funds of the Trust account in breach of trust, the banker must stop payment of the cheques drawn on such account.

8. Defective title of the party

If any person presenting a cheque has defective title to the cheque, and the banker is aware of the fact, he can refuse to honor such a cheque without any

risk because if he makes payment of the cheque to such persons, it will not be made in good faith and the payment will not be deemed as payment in due course.

9. Other circumstances

The banker can refuse payment in the following circumstances:

- ★ If the cheque is a post-dated cheque or a stale-cheque.
- ★ If the cheque is drawn on another branch of the same bank
- ★ If the cheque contains an apparent material alteration not authenticated by the drawer.
- ★ If the signature of the drawer is forged or does not tally with the specimen signature.
- ★ If sufficient funds are not available in the customers account.

15.4 BANKER'S REPLIES TO DISHONORED CHEQUES

When a banker dishonors a cheque for whatever reason, he has to give a reason for dishonoring the cheque. Every bank has printed slip containing various reasons for dishonoring a cheque. This is called "Return Memo". The relevant reason in a given case is tick marked (") on the return memo and the same is enclosed with the cheque. A specimen of a Return Memo is given in the following page.

15.5 BOUNCING OF CHEQUE AN OFFENCE

The bouncing of a cheque due to insufficiency of funds, is treated as an offence from April 01, 1989. The offender can be subjected to a term of one year in prison or a fine twice the amount of the cheque or both, if he fails to make the payment within 15 days of receiving the notice informing him of the bouncing of cheque. The salient points to be remembered are as follows:

- ★ The cheque in question should have been issued in discharge of whole or part of a debt or a liability. A cheque given as gift will not fall in this framework.
- ★ The cheque in question should be presented within six months or its specific validity period, whichever is earlier.
- ★ The payee or holder should give notice demanding payment within 15 days of his receiving information of dishonour, which should be for no other reason other than insufficiency of funds.
- ★ Drawer can make payment within 15 days of receipt of notice and only if he fails to do so, he is liable to be prosecuted.
- ★ Complaint can be made only by the payee or holder in due course within one month of such bouncing.

INDIAN OVERSEAS BANK

H O : Anna Salai, Chennai-600 002.

.........................Branch

RETURN MEMO

Cheque No: .... dated .... For Rs..................... is returned for the reason no______.

1. Refer to drawer.
2. Not arranged for.
3. Effect not yet cleared, please present again.
4. Exceeds arrangement.
5. Full cover not received.
6. Payment stopped by the drawer.
7. Insufficient funds.
8. No account / Account closed / Account transferred to ....Office.
9. ....payee's name / endorsement incomplete / required.
10. ....payee's endorsement illegible / irregular.
11. Endorsement requires bank's guarantee / confirmation.
12. Drawer's signature incomplete / differs / required.
13. Cheque is mutilated / post dated / our of date / without date.
14. Amount in words and figures differ.
15. No advice.
16. Clearing stamp required to be cancelled on the back / incomplete.
17. Alteration requires drawer's full signature.
18. Cheque drawn on our ....office.

DATED:______________ ACCOUNTANT

Let us sum up

The paying banker enjoys statutory protection with respect to payment of cheques provided he takes certain precautions. The cheque drawn should be in proper printed form. The cheque should bear a date. It should not be a stale cheque or a post dated cheque. A post-date cheque can be presented for payment only on the date mentioned therein. Amount should be clearly

mentioned in words and figures, the amount should not differ. There should be sufficient funds in the customers account to honor a cheque by the paying banker. In case a number of cheques are presented on a single day, the banker should honor the cheques in the chronological order. A cheque which contains material alterations requires the full signature of the drawer to be honored by the paying banker.

The Negotiable Instrument Act provides protection to the paying banker in many occasions provided the payment is made in due course. The mutilated cheque may be dishonored if the mutilation indicates cancellation of cheque. It is responsibility of the banker to pay the cheque only during banking hours.

The paying banker can refuse payment when the drawer countermands payment, and on the death, insolvent and insanity of the drawer. When a cheque is returned a return memo is prepared indicating the reason of dishonor. Dishonoring a cheque due to insufficiency of funds is a criminal offence and the drawer will be imprisoned if he does not pay the cheque within fifteen days of notice by the payee.

Check your progress – II

Answer whether the following is true of false:

1. Dishonoring a cheque is not an offence. (True/False)
2. Banker can refuse payment of a cheque containing apparent material alteration (True/False).
3. A return memo is a slip indicating the reason of dishonor. (True/False)
4. The banker is not bound to honor a cheque when the drawer becomes Insane. (True/False)
5. When a cheque is specially crossed the paying banker should make the payment only through the specified banker. (True/False)

Answers to check your progress

Check your progress – I

1. Mutilated; 2. Banking hours; 3. Post-dated

Check your progress – II

1. False; 2. True; 3. True; 4. True; 5. True

Glossary

Stale cheque : If the cheque bears a date earlier to the writing of the cheque is known as a stale cheque.

Post-Dated Cheque : If the drawer mentions a future date on the cheque when it is drawn it is called as post-dated cheque.

Material Alterations : An alteration is considered as material alteration if it affects the operation of the instrument substantially and the liability of the parties concerned is changed significantly.

Return Memo : A slip indicating the reason for dishonor is known as a return memo.

Model Questions

1. What are the precautions to be taken by the paying banker before honoring a cheque?
2. Explain the legal effects of material alteration.
3. Explain are the statutory protection available to the paying banker
4. When can the paying banker refuse to pay a cheque?
5. Explain the liability of the drawer if a cheque is dishonored.

Unit 16

COLLECTION OF CHEQUES

STRUCTURE

Overview
Learning Objectives
16.1 Collection of cheques
16.2 Legal status of the collecting banker
16.3 Conversion of the collecting banker
16.4 Statutory protection to the collecting banker
16.5 Collecting banker's duties to his customer
16.6 Liability of the collecting banker in respect of Agent appointed for collection
16.7 Instructions of the Reserve Bank of India to the collecting banks
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

It may be said that there is in theory, no legal obligation on a banker to collect cheques, drawn upon other banks for a customer. However, the collection of cheques and bills on behalf of customers is an important function of almost every modern bank because it provides the facility which can hardly be dispensed with especially in case of crossed cheques. In performing this function, the banker should be careful, otherwise, they may land in difficulties. Having discussed the statutory protection available to the paying banker, in this section the statutory protection available to the collecting banker is analyzed.

LEARNING OBJECTIVES

Having explained the statutory protection to the paying banker in the earlier Unit, this section describes lucidly the statutory protection available to the collecting banker. The following facts are analyzed:

- Legal status of the collecting banker
- Conversion of the collecting banker
- Statutory protection to the collecting banker
- Collecting banker's duties to his customer

- Liability of the collecting banker in respect of Agent appointed for Collection
- Instructions of the Reserve Bank of India to the collecting banks

16.1 COLLECTION OF CHEQUES

Collection of cheques on behalf of a customer is an indispensable service rendered by a banker to his customer. A customer of a banker receives a cheque drawn on any other banker; he has two options before him -

1) Either to receive his 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.

When a banker is deputed to collect the amount of the cheque on behalf of the customer and credits it to the customer's account is known as "the collecting banker". According to the law the collecting banker is defined as "The collecting banker is any bank, other than the remitting bank, involved in processing the collection order"

16.2 LEGAL STATUS OF THE COLLECTING BANKER

The law as such has not imposed any duty on that bank to collect the cheques, dividend warrants and other allied instruments. The bank may refuse to collect them if it feels like. But collection of cheque has become ~~so~~ common **a** practice of banks now that is almost a part of their normal functioning. One will hardly find a bank which will decline to undertake this activity. Instead, the business involved on such collection has become enormous and the legal difficulties considerable, owing to the risks that the customer may have no title or defective title. When a banker collects his customer's cheques, he acts as:

a) As holder for value: A holder for value is one who holds a cheque for which the value has at some time been given though not necessarily by the holder himself. In this context, the term arises when the banker who is collecting the proceeds of a cheque has himself given value. This happens when a banker credits the amount of the cheque and allows him to draw against or otherwise pay the amount thereof to the customer before the proceeds are actually realized from the drawee bank. This facility is given to the customer since some time is always involved between the presentation of the cheque up to the time proceeds can be made available for drawing.

According to Sir John Paget, a holder becomes a holder for value in any of the following circumstances:

- By lending further on the strength of the cheque;

- By paying over the amount of the cheque or part of it in cash or in account before it is cleared;
- By agreeing either then or earlier or as a course of business the customer may draw before the cheque is cleared;
- By accepting the cheque in avowed reduction of an existing overdraft or some other indebtedness; and
- By giving cash over the counter for the cheque at the time it is paid in for collection.

In any of these circumstances, the banker becomes the holder for value and also the holder in due course. He bears the liability and possesses the rights enjoyed by the holder for value. If the last but one endorse is proved to be forged, he will be liable to the true owner of the cheque, but he can recover the money from his customer. If the cheque sent for collection is dishonored, the banker can sue all the previous parties giving due notice of dishonor. It is essential that the amount of the cheque is paid to the customer in good faith.

b) 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 realized from the drawee banker. Thereafter 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 form outstation banks.

As an agent of his customer, the collecting banker does not posses 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 him did not belong to his customer, he will be held liable for 'conversion of money', i.e., illegally interfering with the rights of the true owner of the cheque.

16.3 CONVERSION OF THE COLLECTING BANKER

Sometimes a banker is charged for having wrongfully converted cheques to which his customer had no title or had defective title. Conversion means wrongful or unlawful interference (that is using, selling, occupying or holding) with another person's property which is not consistent with the owner's right of possession. Negotiable Instrument are included in the term 'Property' and hence a banker may be charged for conversion, if he collects cheques for customer who has no title or defective title to the instrument. The basic principles that a rightful owner of the goods can recover the same from anyone who takes it without his authority and in whose hands it can be traced. When the banker acts as an agent of his customer for the collection of this cheque, he cannot escape this liability. However, the right of the true owner is a

restricted one and cannot be exercised in case the goods reach the hands of one who:

- Receives it in good faith
- For value, and
- Without the knowledge that the other party had no authority thereon.

16.4 STATUTORY PROTECTION TO THE COLLECTING BANKER

Each day a banker collects a great number of cheques on behalf of innumerable customers, and if he were called upon to examine the validity of title in each such case, one can well imagine the loss of time and effort, and above all the loss of 'dispatch' which is crucial in banking business. Verification of title in every cheque to be collected will result in an incalculable delay all round to the great detriment of business transactions. The Negotiable Instrument Act has therefore provided protection to the collecting banker so as to minimize the risks of conversion involved in collection of cheques. Section 131 provides protection to the collecting banker, which read as follows:

"A banker who has in good faith and without negligent received payment for a customer of a cheque crossed generally and specially to himself shall not, in case the title of the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment"

Thus, it is clear that this protection is limited and a collecting bank will be protected only if it brings itself within the following conditions:

1. **Crossed Cheques:** It is only in respect of crossed cheques that the collecting banker enjoys certain amount of protection. To be entailed to protection, the cheques have to be crossed generally or specially before it reaches the banker's hands. If a cheque was not crossed at the time it was paid into, the bank cannot secure protection by crossing it later. It may be noted that it is a common practice among bankers to cross cheques received by them with a rubber stamp of the collecting banker, but this does not help. In collecting an open cheque, the bank can be held liable for conversion and as such answerable to the true owner for the value, if the customer had no title or a defective title thereto.

2. **Person must be a customer:** The statutory protection is available only when the banker collects the cheque on behalf of a customer. A customer is one who has an account with the banker and his dealing with the latter are in the nature of banking business. The statutory protection cannot be availed of in case of a cheque sent to banker by a person who is not a customer of the banker. The statutory protection is available to the banker if he collects the cheque as an agent of the customer and not as its holder for value. As the holder for value the collecting banker becomes its rightful owner and cannot

avail of the statutory protection. The collecting banker does not lose statutory protection he credits his customer's account with the amount of the cheque before its actual realization but the customer is allowed to draw the amount only after its realization

3. Receives payment in good faith and without negligence: The most essential prerequisites for availing of the statutory protection are that the banker must receive payment in good faith and without negligence. In good faith means an act is done honestly whether negligently or not. The onus of proof that he was not negligent in collecting the cheque lies on the banker himself. Negligence depends on the circumstances of each case. In case there are circumstances to suspect the right of the customer to the cheque, the banker must make proper enquires and take adequate precaution. Failure to do so will constitute negligence. Though a banker duty is to the customer but he is responsible to the true owner. In the following cases the collecting banker is said to have acted negligently:

★ If a banker opens an account in the name of an undesirable person without proper and satisfactory introduction, the banker is held to be negligent. The banker should ensure that the customer gives proper references while opening a bank account. Referee should be known to the banker or else the banker should make enquiries of the same. In case of married women the name and occupation of the husbands should be ascertained.

★ The collecting banker should verify the correctness or regularity of the endorsement on the order cheque. The collecting banker should note that the endorser has signed in the same manner or spelling as it appears in the name of the payee. If two or more endorsement are in the same handwriting the banker should make enquiry. If endorsements are not verified by the collecting banker then he will no get statutory protection.

★ The collecting banker should make enquiries if the amount of the cheque is for a large amount; if a partner, employee or director of a firm or company or trustee of a trust sends cheque payable to the firm or company or trust respectively duly endorsed to be credited into his personal account. The history of the account to which the amount is to be credited, the antecedents of the customer, and the relationship between the payee and drawer should be considered while conducting enquiries.

★ A collecting banker should carefully examine the title of the prior parties before accepting for collection a cheque with 'Not Negotiable' crossing, because the title of the transferee shall not be better than that of the transferor.

★ A crossing with the words "Account Payee Only" is an instruction or a caution to the collecting banker to collect such cheque and credit the proceeds

to the account of the payee only. The collecting banker should adhere to this instruction strictly to avail protection.

16.5 COLLECTING BANKER'S DUTIES TO HIS CUSTOMER

a) Due care and diligence in collection of cheques: As his customer's agent, the collecting banker is bound to show due care and diligence in the collection of cheques given to him. If he fails in his duty or neglects to use the recognized channel for the purpose and, as a direct consequence of his negligence, his customer suffers a loss, the collecting banker will be required to make good that loss. For instance, If a banker to whom, cheques have been given for collection fails to present them within a reasonable time, his customer will hold the collecting banker liable for any loss that he suffers. A banker has a contractual duty to exercise care and skill for collecting cheques on behalf of a customer.

b) Notice of dishonour: The collecting banker should show due diligence in informing his customer about the dishonour of a cheque so as to enable him to recover the amount from the parties liable on the same. Generally, bankers present the cheques to be collected on the same day on which they are received or on the following working day with a two bankers ie, the collecting and the paying banker, are in the same city. Where it is not possible to present the cheque on the date of its receipt, the collecting banker puts a rubber stamp reading "too late for today's clearing" on the counterfoil of the paying in slip. If the banks are in two different cities, the collecting banker should send the cheque to his agent in the town where the particular branch of the drawee bank is, either on the same day or on the following working day. The same rule applies to the notice of dishonour. Failure to do so may result in the banker having to suffer loss. Though a notice of dishonour may be given over the telephone or through a telegram, it is advisable to confirm the same by a letter.

c) Position in case the collecting and paying bank is the same: when the cheque paid in happens to be drawn on the same office of the bank, it can legally be held over till the close of the following working day. Generally, such cheques are honored or returned before the close of business on the day they are paid in. In case the customer asks for and is given a definite answer in the affirmative, the cheque will have to be treated as paid.

16.6 LIABILITY OF THE COLLECTING BANKER IN RESPECT OF AGENT APPOINTED FOR COLLECTION

The collecting banker collects the amount of the cheque from the paying banker through its own branch at the place of the paying banker. If there is no branch of the collecting banker at the place, it appoints another banker, having a

branch at that place as it agent for collection. The status of such banker could be that of a sub-agent or a substitute agent. The agent is responsible to the principal for the acts of the sub-agent, while in case of the substitute agent the principal is responsible. The substitute agent is a person named by the agent holding an express or implied authority to act for the principal in the business of agency.

16.7 INSTRUCTIONS OF THE RESERVE BANK OF INDIA TO THE COLLECTING BANKS

The Reserve Bank of India has advised the banks to avoid delay in the collection of outstation cheques and to adopt new systems, procedures and infrastructure arrangement to ensure quick collection of such cheques. The central bank have prescribed the following for crediting the amount to the customers account:

★ Banks are required to give in the normal course immediate credit up to Rs.7500 to a customer for local as well as outstation cheques, subject to the satisfactory operation of the customer's account.

★ In the four metropolitan centres having MICR cheque clearing system the amount of a cheque drawn on a bank located at any of the other three metropolitan centres and presented for collection on any day in a week should be credited in the customers account latest by the same day in the following week.

★ In case of state capitals and other centre with more than 100 bank offices, credit to the customer's account should be given within ten days and the customer be allowed to withdraw even if collection advice are not received.

★ In case of local cheques, the customer's account should be credited latest by the third working day.

★ For the above mentioned facility the banks re not allowed to charge any charges. But if the cheques are returned then the banker can charge at commercial rate.

★ To protect the interest of the collecting banker the reserve bank advised that this facility may be extend only to satisfactorily operated accounts up to a maximum of Rs.10,000.

Check your progress

Answer the following short questions:

1. How does the banker act when he collects a customer's cheque?
2. Define a collecting banker.
3. What do you mean by the term received in good faith?

Let us sum up

Collection of cheques on behalf of the customer is the major work all banks. The banker acts as a agent of his customer while collecting cheques on his behalf. The banker should act in good faith and without negligence. The collecting banker should follow the instruction as per the crossing while crediting the amount in the customers account. The payment must be received only on behalf of his customer. While opening an account the collecting banker should require for proper introduction and reference. If there are any irregularities in any endorsements the banker should make necessary enquiries.

It is the duty of the collecting banker to present the customers cheques within reasonable time. When there are any dishonors of cheques the banker should immediately intimate the customer. The Reserve Bank of India has notified certain instructions regarding collection of cheque.

Glossary

Collecting banker : The collecting banker is any bank, other than the remitting bank, involved in processing the collection order.

Holder for value : A holder for value is one who holds a cheque for which the value has at some time been given though not necessarily by the holder himself.

Good faith : It means an act is done honestly whether negligently or not.

Answers to check your progress

1. The collecting banker acts as a holder in value and as an agent.
2. The collecting banker is any bank, other than the remitting bank, involved in processing the collection order.
3. It means an act is done honestly whether negligently or not.

Model Questions

1. Explain the legal status of the collecting banker.
2. What do you mean by the term conversion by the collecting banker?
3. What are the duties of the collecting banker?
4. Enumerate the instructions given the Reserve Bank of India to the collecting Bankers.

BLOCK V

LOANS AND ADVANCES

Unit - 17 : Loans and advances by commercial banks

Unit - 18 : Modes of creating charge

Unit - 19 : Advances against securities

Unit - 20 : Pruchase and Discountry of Bills

Unit 17

LOANS AND ADVANCES BY COMMERCIAL BANKS

STRUCTURE

Overview
Learning Objectives
17.1 General Principles guiding the banker in lending
17.2 Bank credit in tune with national policies
17.3 Style of Credit
17.4 Compulsory Loan components in bank credit
17.5 Credit worthiness of borrowers
17.6 Sources of collecting credit information
17.7 Factors limiting the level of a bank's advances
17.8 Consortium Advances
17.9 Participation Certificates
17.10 Other Directive on advances
17.11 Commercial Paper
17.12 Interest Rates for advances for scheduled commercial banks
17.13 Interest on loans at monthly rests
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

The main business of the banking company is lending of funds mainly to trades business and industrial enterprises. The major portions funds are employed by way of loans and advances. The most important method by which a banker deploys his funds is by the grant of loans and overdrafts and the purchase and discounting of commercial bills. There is no fundamental difference between the different forms in which bankers give accommodation to their customers. This unit highlights the intricate details that are to be followed by the banker while granting loans. The lending function of banks is so important in modern times, that it is almost impossible to disregard it in the case of any bank, much less in the case of commercial banks. Although receipts from exchange, commission, and banker's charge, contribute a fair amount of the profits of a commercial bank, its earnings are chiefly derived from interest charged on loans and discounts. Hence this is an important issue which is discussed in this unit.

LEARNING OBJECTIVES

The various issues discussed in this unit are:

- General Principles guiding the banker in lending, in tune with national policies
- Style of Credit
- Assessment criteria of borrowers credit worthiness, Sources of collecting credit information
- Factors limiting the level of a bank's advances
- Consortium Advances and Participation Certificates
- Commercial Paper
- Interest Rates for advances for scheduled commercial banks

17.1 GENERAL PRINCIPLES GUIDING THE BANKER IN LENDING

Safety: "Safety first" should be the first guiding principle of a banker, so far as his advances are concerned, because the very existence of a bank depends on the safety of its outstanding, which should never, therefore, be sacrificed to the profit–earning capacity of his advances. By safety is meant that borrower is in a position to repay the loan, along with interest, according to the terms of the loan contract. The repayment of the loans depends upon the borrower's:

(a) capacity to pay and

(b) willingness to pay.

This has led people to believe that a bank will never advance any loans unless, it is fully secured. Such is no doubt the ideal conception of banking, but as a result of competition from other banks, every bank has sometimes to grant loans to its customer against their personal security. The manager in such cases uses his discretion and never lends beyond the customer's resources. The *capacity to pay* depends on tangible assets and success of business. The *willingness to pay* means honesty and character of the borrower. Scrupulous care should be taken to see that funds lent out are not subject to any risk of being lost.

Liquidity: Secondly, the banker by making advances must see that the money, he is lending, is not going to be locked up for a long time. This could make loans and advances less liquid and more difficult to realise in case of emergency. In fact, it is not the function of commercial banks to give loans, which are more or less of a permanent nature. Usually it is a part of the circulating capital of a commercial or industrial concern which is expected to be provided by a commercial bank, so that the loans become payable on demand. Therefore, the banks lent for short periods and mainly for working

capital purposes. The banker must ensure that liquidity of loan is possible at the shortest time without much loss.

Profitability: Commercial banks are profit earning institutions. They employ funds profitably so as to earn sufficient income, out of which interest can be paid to the depositors, salary to the staff and to meet various establishment expenses and distribute dividend to the shareholders. Earlier, the rates of interest charged were based on Reserve Bank directives. Now, the banks are free to determine their own rates on advances above Rs.2, 00,000. A customer with high reputation may be charged a lower rate, when compared to ordinary customers. The difference between the borrowing and lending rates constitute gross profit. No hard and fast rule is laid down regarding this margin. But generally, two to two and a half percent is considered reasonable. The sound principle of lending is not to sacrifice safety or liquidity for the sake of higher profitability.

Purpose of loan: The purpose for which the loan is required and the resources wherefrom the borrower is expected to repay have also an important bearing not only on its liquidity, but is desirability too If the loan is required for a nonproductive and speculative purpose, the banker should think twice before entertaining the proposition. Even though the proposition may appear to be otherwise a good business it may have to be declined for being contrary to the national interests. It may be stated that there is now a certain amount of "official control" on bank advances and a banker has to keep within the four walls of such control. For instances section 21 of the Banking Regulations Act of 1949 empowers the Reserve Bank *inter alia* to determine the policy to be followed by banks, and to give direction to the purpose for which the advances may or may not be made. These powers have been invoked by the Reserve Bank through selective credit regulations measures.

Banker's loans generally repayable on demand: Bankers generally make their loans repayable on demand, although there may be an understanding that the customer would be allowed to use the funds for at least a certain period, provided he complies with the terms of the agreement. They also reserve to themselves the power of canceling or reducing the amounts of advances, but generally they have to give a reasonable notice. For instance, if a banker who has promised his customer an overdraft to the extend of Rs.10,000, wishes to reduce its amount to Rs.5000, he cannot refuse to honor his customer's cheques issued before the receipt of the notice by the customer, so long as they do not exceed the limit of the overdraft originally agreed upon.

Not to invest all funds in one industry or in any one Group of Industries: It is also necessary to remember that a prudent banker must avoid lending the major portion of his funds in meeting the needs of any one industry or any

one group of industries for considerations of self interest as well a the larger public good. The imprudence of putting one's all eggs in one basket cannot be too often reiterated. It should also be stated that it is better for a banker to advance moderate sums to a large number of customers, in preference to lending large sums to a few customers.

17.2 BANK CREDIT IN TUNE WITH NATIONAL POLICIES

Banking institutions are amongst the commanding the heights of an economy. They must serve the national policy and objectives. Twenty major banks in India were nationalized "to serve better the needs of development of the economy in conformity with the national policies and objectives". Necessary changes in the banking policies and practices were urgently necessitated in the wake of nationalization to serve wide: social purpose of establishing democratic socialism in the country.

Significant changes have taken place in the concept of security observed by the bankers in their attitude towards the hitherto weaker and neglected sections of society during the last two decades. Banks have been directed to finance on a large scale agriculturists, small industrialists, professional persons and transporters, etc. Banks have also bee asked to help in the implementation of the 20-point programme. They have been directed to ensure that banks' advances within the priority sectors are given increasingly to the weaker and underprivileged sections at concessional rate of interest. Security of funds lent is not sought exclusively in the tangible assets of the borrower but also in his technical competence, managerial ability, honesty and integrity. Loans are being given in large numbers for the setting up of small business or for starting practice by professional persons. The Deposit Insurance and Credit Guarantee Corporation guarantee such loans. It is to be noted that bank credit has to act as an important instrument for achieving wider social purpose, national policies and objectives. However, the basic principles of sound lending are fundamentally and are observed even by the nationalized banks. The ways in which the basic principles are followed, of course, may be modified to suit the needs of the hour.

17.3 STYLE OF CREDIT

Commercial banks finance working capital requirements of their customers in the following styles.

1) Cash Credit System
2) Overdraft
3) Loan System
4) Purchase and Discounting of Bills.

Cash Credit system, overdraft, Loan systems are dealt in this chapter. Purchasing and discounting of Bills are dealt in Unit…….

Cash Credit: A cash credit is an arrangement by which a banker allows a customer to borrow money up to certain money against either a bond of credit by one or more sureties or certain other securities. This is the most favorite mode of borrowing by large commercial and industrial concerns in India. The advantage is that the customer need not borrow at once the whole of the amount he requires, but draw the amount as and when required. The banker has to estimate customer's requirements so that he may not lose interest on the funds remaining idle. Generally banker's cash credit agreement stipulates "one-half or one-quarter interest clause". In this stipulation, the customer has to pay interest on at least one half or one quarter of the amount of cash credit limit allowed to him even when he does not use the account. The other features of cash credit arrangements are as follows:

- ★ The banker fixes the cash credit limit, considering the working of the borrowing concerns such as production, sales, inventory levels, past utilization of such limits, etc.
- ★ The advance sanctioned is repayable on demand technically, but in practice, they 'roll over' over a period of time.
- ★ Under this arrangement, the banker keeps adequate cash balances to meet customer's demands as and when it arises.
- ★ The customer is charged interest only on the actual amount utilized by him but, on the unutilized limits kept as idle, *commitment charge* is levied.

The following are the merits of the system:

1) The system ensures less cost of funds to the borrowers and better turnover of funds for the banks.
2) Banks have to maintain one account for all the transaction of a customer, thus avoiding repetition.

The demerits are:

1) The limits are prescribed once in a year, hence there is a tendency to fix large limits.
2) The end use of funds is not verified by the banker which could be used for unapproved purposes.
3) There is lack of proper management of funds because borrowing limits may be fixed by the borrower.

The Reserve Bank of India, considering the above demerits, issued guidelines for reforming the cash credit system on the basis of the recommendations of Tandon Committee and Chore Committee.

COMMITMENT CHARGE:

Under the cash credit system banks prescribe the cash credit limits for the customers on an annual basis. Customers are at liberty to draw against such limits as per their actual requirements. Banks charge Interest from the day of withdrawal only. Therefore, to avoid the loss caused to the banks by the non-utilization of cash credit limit to the full extent, a charge known as the commitment charge is made by the banks. This charge is imposed on the unutilized portion of the cash credit limits only and its rate happens to be a nominal one.

In India, the Reserve Bank made it obligatory for all scheduled commercial banks to levy a commitment charge @ 1 per cent per annum on the unutilized portion of the credit limits in excess of Rs. 10,00,000 with effect from 1st April, 1970. With effect from January 1, 1991 commitment charge was levied with two objectives, namely

(1) to bring about discipline in availing bank finance by borrowers and

(2) to facilitate better funds management by banks.

The salient features of the directive given by the Reserve Bank to banks in this regard are as follows:

★ It will apply to all borrowers with working capital limits (fund based) of Rs. 1 crore and over.

★ It will be imposed @ 1% p.a. on the unutilized portion of working capital sanctioned to borrowers, subject to a tolerance level of 15% of the quarterly operating limit. It means that no charge is to be made if the operating limit specified by the borrower for a given quarter remains unutilized within the range of 15% only.

★ The "unutilized portion" of the operating limit shall be ascertained by the banks by calculating the average utilization during the quarter, after excluding therefore utilization in excess of the operative sanctioned limit. The difference between the average utilization thus determined and the operative sanctioned limit, as the case may be, shall be treated as unutilized portion.

★ Where the unutilized portion (as determined above) exceeds the tolerance level of 15%, the charge is to be imposed on the entire unutilized portion of operative/sanctioned limit and not only on the portion in excess of the tolerance level.

★ This charge will not be imposed on the following limits:

a) working capital limits sanctioned to sick/weak units

b) limits sanctioned for export credit and against export incentives

c) Inland bill limits

d) Credit limits granted to commercial banks, financial institutions and co-operative banks.

The above mandatory requirement to levy a commitment charge on unutilized portion of the Cash Credit limits was withdrawn with effect from July 1, 1996. The Reserve Bank has advised the banks to evolve their own guidelines to ensure credit discipline and levy a commitment charge.

Overdraft:

When a current account holder is permitted by the banker to draw more than what stands to his credit, such an advance is called an overdraft. The banker may take some collateral security or may grant such advance on the personal security of the borrower. The customer is permitted to withdraw the amount as and when he needs it and to repay it by means of deposit in his account as and when it is feasible for him. Interest is charged on the exact amount overdrawn by the customer and for the period of its actual utilization.

Generally an overdraft facility is given by a bank on the basis of a written application and a promissory note signed by the customer. In such cases an express contract comes into existence. In some cases, in the absence of an express contract to grant overdraft, such an agreement can be inferred from the course of business. Banks should, therefore, obtain a letter and a promissory note incorporating the terms and conditions of the facility including the rate of interest chargeable in respect of the overdraft facility. This is to be complied with even when the overdraft facility might be temporary in nature.

Loan system:

Under the loan system, credit is given for a definite purpose and for a predetermined period. Normally, these loans are repayable in installments. Funds are required for single non-repetitive transactions and are with-drawn only once. If the borrower needs funds again or wants renewal of an existing loan, a fresh request is made to the bank. Thus, a borrower is required to negotiate every time he is taking a new loan or renewing an existing loan. Banker is at liberty to grant or refuse such a request depending upon his own cash resources and the credit policy of the central bank.

Advantages:

- ★ The time of repayment of the loan or its installments is fixed in advance; this system ensures a greater degree of self-discipline on the borrower as compared to the cash credit system.
- ★ Whenever any loan is granted or its renewal is sanctioned, the banker gets an opportunity of automatically reviewing the loan account. Unsatisfactory loan accounts may be discontinued at the discretion of the banker.

- ★ The system is comparatively simple. Interest accrues to the bank on the entire amount lent to a customer.

Disadvantages:

- ★ Every time a loan is required, it is to be negotiated with the banker. To avoid it, borrowers may borrow in excess of their exact requirements to provide for any contingency.
- ★ Banks have no control over the use of funds borrowed by the customer. However, banks insist on hypothecation of the asset/vehicle purchased with the loan amount.
- ★ Though the loans are for fixed periods, but in practice they roll over, i.e., they are renewed frequently.
- ★ Loan documentation is more comprehensive as compared to cash credit system

Types of loans:

Short-Term Loans: Short term loans are granted to meet the working capital needs of the borrowers. These loans are granted against the security of tangible assets-mainly the movable assets like goods and commodities. Reserve Bank of India has made it mandatory for the banks to grant a portion of bank credit to big customers in the form of loans, which may be for various maturities. The Reserve Bank has also permitted the banks to roll over such loans, i.e., to extend the loan for another period at the expiry of the tenor of the first loan.

Term Loans: Medium and long term loans are usually called 'Term Loans'. These loans are granted for more than a year and are meant for purchase of capital assets for the establishment of new units and for expansion or diversification of an existing unit. Banks usually grant such loans together with specialized financial institutions like Industrial Finance Corporation etc. Such loans constitute a part of the 'project finance' which industrial enterprises are required to raise from different sources. These loans are usually secured by the tangible assets like land, buildings, plant and machinery, etc. Banks can grant loans for infrastructure projects within the exposure norms.

In October 1997, Reserve Bank of India permitted banks to announce separate prime term lending rate (PLR) for term loans of 3 years and above. In April 1999 Reserve Bank permitted the banks to operate different PLRs for different maturities provided transparency and uniformity of treatment is maintained. Reserve Bank also permitted the banks to offer fixed rate loans to borrowers requiring project finance. It means that the interest rate on term loans may remain unchanged through the period of the term loan, in spite of change in the interest rates on new loans.

Bridge Loans: Bridge loans are essentially short term loans which are granted to industrial undertakings to meet their urgent and essential needs during the period when formalities for availing of the term loans sanctioned by financial institutions are being fulfilled or necessary steps are being taken to raise the funds from the capital market. These loans are granted by banks or by financial institutions themselves and are automatically repaid out of amount of the term loan or the funds raised in the capital market.

Reserve Bank permitted the banks to sanction bridge loans subject to the following conditions:

★ The prior consent of the other bank/financial institution which has sanctioned a term loan must be obtained.

★ The term lending bank/financial institution must give a commitment to remit the amount of the term loan to the bank concerned.

★ The period of such bridge loan should not exceed four months.

★ No extension of time for repayment of bridge loan will be allowed.

★ To ensure that bridge loan sanctioned is utilized for the purpose for which the term loan has been sanctioned.

In November 1997, Reserve Banks permitted the banks to grant bridge loans to companies (other than non-banking finance companies) against public issue of equity in India or abroad. The guidelines for sanction of such loans are to be laid down by each bank and should include the following aspects:

★ Security to be obtained for the loan

★ The quantum of outstanding bridge loan (or the limit sanctioned, whichever is higher) during the year.

★ Compliance with individual/group exposure norms.

★ Ensuring end use of bridge loan.

★ The maximum period of the bridge loan to be one year.

Composite Loans: When a loan is granted both for buying capital assets and for working capital purposes, it is called a composite loan. Such loans are usually granted to small borrowers, such as artisans, farmers, small industries etc. The limit up to which such loans may be granted by banks has recently been raised from Rs.5 lakhs to Rs.10 lakhs.

Consumption Loans: Though normally banks provide loans for productive purposes only, but as an exception loans are also granted on a limited scale to meet the medical needs or the educational expenses or expenses relating to marriages and other social ceremonies etc. of the needy persons. Such loans are called consumption loans. In cities, banks have started granting loans for the purchase of durable consumer goods, like cars, TV, fridge etc. Such loans are called "Personal Loans".

Secured and Unsecured Loans: The loans and advances granted by banks are broadly classified into (i) secured and (ii) unsecured advances.

According to Section 5 (a) of the Banking Regulation Act, 1949, "a secured loan or advance' means a loan or advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance; and 'unsecured loan or advance' means a loans or advance not so secured. "

Thus, the distinguishing features of a secured loan or advances or as follows:

- ★ The loan must be made on the security of tangible assets like goods and commodities, land and buildings, gold and silver, corporate and government securities, etc. A charge on any such assets offered as security must be created in favor of the banker.
- ★ The market value of such security must not be less than the amount of the loan at any time till the loan is repaid. If the former falls below the latter because of decline in the market prices, the loan is considered as partly secured.

The distinction between secured and unsecured loan is made on the basis of legal title or charge created in favor of the lender. Unsecured loans, also called clean loans and advances, are granted to persons without observing the above-mentioned criterion of credit worthiness. In fact, unsecured loans are granted to persons of sufficient means, possessing tangible assets and with sound financial position, but no charge or right are created on any such assets of the borrower in favor of the banker. In such cases, the security happens to be the personal obligation of the borrower which is sometimes supported by a guarantee given by a third party regarding the repayment of the loan. Clean advances are obviously granted to parties enjoying high reputation and sound financial position. Unsecured advances are granted with caution and within certain limits only because in case of default by the borrower, the banker stands at par with other unsecured creditors. Reserve Bank of India has, therefore, prescribed an exposure limit for unsecured advances.

In case of secured advances, the legal status of the banker is that of a secured creditor; he gets the first and absolute right to recover his dues out of the sale proceeds of the assets over which a charge is created in favor of the banker.

Guaranteed Advances: These advances are covered by guarantees given by third parties. They may be individuals, firms, companies, banks or even government. In such cases the third party known as surety or the guarantor makes a promise to repay the amount of the loan and other charges to the bank concerned, incase the principal debtor defaults in doing so. Their

significance lies in the fact that the advance is covered by the promises of two parties – the principal debtor and the surety.

Loans without collateral: Reserve Bank of India issued instructions to the banks to dispense with the collateral requirement for loans upto Rs.1 lakh granted to the Small-scale industrial units. This limit was increased for the tiny sector to Rs.5 lakhs in the Central Budget for 2000-01. In its credit policy announced on April 29, 2002, Reserve Bank of India allowed the banks to increase the limit for loans without collateral security granted to small-scale industrial units from Rs.5 lakhs to Rs.15 lakhs on the basis of good track record and the financial position of the units. In its credit policy of November 2003, Reserve Bank of India has further enhanced this limit to Rs.25 lakhs.

17.4 COMPULSORY LOAN COMPONENTS IN BANK CREDIT

In April 1995, Reserve Bank of India introduced a compulsory loan component in the bank credit granted to large borrowers. Its objective is to bring about discipline in the utilization of bank credit and to gain better control over the flows of credit. The revised directive of the Reserve Bank is as follows:

- ★ This stipulation is applicable to all borrowers with working capital of Rs.10 crores and above from the banking system.
- ★ A uniform percentage of loans of 80% and cash credit at 20% has been prescribed for such borrowers.
- ★ Banks shall have to increase the loan component to 80% and reduce the cash credit component to 20%.
- ★ In case of borrowers below Rs.10 crore limits, banks may settle the same with the borrowers.
- ★ The minimum period of loan may be fixed by banks in consultation with borrowers. Loans with different maturities may also be granted.

Credit Exposure Norms: Taking into account the best international practices, the Reserve Bank of India made the following modifications in exposure norms while announcing its Credit Policy of April 19, 2001:

(1) The concept of capital funds was broadened to include total capital (Tier I and II) as defined under Capital Adequacy Standard laid down by Reserve Bank of India. It means that the Rupee subordinated debt raised by banks as Tier II Capital has also been included in the term capital funds for determining exposure norms. This was made effective from March 31, 2002.

(2) The exposure ceiling for a single borrower has been reduced from existing 20% to 15% of capital funds and for a group of borrowers from 50% to 40% w.e.f. March 31, 2002. In case of financing of infrastructure projects, the exposure ceiling is 50%.

(3) Non-fund based exposure should be reckoned at 100%.

(4) Banks should include forward contracts in foreign exchange and other derivative products like currency swaps and options, at their replacement Cost Value in determining individual/group borrower exposure ceiling effective April 1, 2003.

To keep the level of unsecured advances within reasonable limit, Reserve Bank of India has prescribed exposure norm for unsecured advances. According to the norm, 20% of a bank's unsecured guarantees plus the total of its outstanding unsecured advances should not exceed 15% of its total outstanding advances. Outstanding advances will not include outstanding Credit Card dues and unsecured advances given to self Help Groups against group guarantees.

17.5 CREDIT WORTHINESS OF BORROWERS

The creditworthiness of a person means that he deserves a certain amount of credit, which may safely be granted to him. Such creditworthiness is judged by the banker on the basis of his (1) character, (2) capacity and (3) capital.

Character: In assessing the creditworthiness of a person, the first consideration is that of the character of the person concerned. The word character implies and includes a number of personal characteristics of a person, e.g. his honesty, integrity, regularity and promptness in fulfilling his promises and repaying his dues, sense of responsibility, good habits and the reputation which he enjoys in the eyes of others. If a person possesses all these qualities, without any doubt or suspicion in the minds of others, he possesses an excellent character and will be considered creditworthy by the banker.

Capacity: The success of an enterprise largely depends upon the ability, competence and experience of the entrepreneur. If the borrower possesses necessary technical skill, managerial ability and experience to run a particular industry or trade, success of such unit may be taken for granted (barring some unforeseen circumstances) and the banker will consider him a deserving case for granting an advance. The significance of this factor is now growing as the banks are willing to grant unsecured loans to technicians and competent persons on the basis of soundness of their business projects, irrespective of their own capital.

Capital: The importance attached by the banker to the adequacy of capital of the borrower is not without significance. Banks are the repositories of the public money and lend the borrowed money. The banker, therefore, does not lend money to an entrepreneur who does not have adequate funds of his own. In case of failure of the business enterprise the banker will be able to realize his money if the borrower's own capital is sufficient.

17.6 SOURCES OF COLLECTING CREDIT INFORMATION

The credit information is collected through the following sources:

Credit Information Bureau: The Reserve Bank of India has established within itself a Credit Information Bureau which collects credit information from the banks under Section 45-C (1) of the Reserve Bank if India Act, 1934. Banks are required to furnish such credit information in respect of credit limits of Rs.5 lakhs and over in case of secured advances and Rs. 1 lakh and over in case of unsecured advances. They mention the nature of facility, security and charge along with outstanding balance. After considering such information in respect of each customer, the Reserve Bank supplies to the applicant-banks information relating to the total limits sanctioned to and the number of banks was dealing with a party. Such information can be secured only in respect of big customers and that too relating to the last Fridays of March, June, September and December every year. Hence, the Bureau is of limited assistance to the banks.

Borrower: Much information may be secured from the borrower directly. The loan application form seeks basic information about the borrower and his business. The banker may examine his account books and note his past dealings with other banks or parties. His pass books with other banks can show his dealings and the business undertaken in the past. A personal interview with the borrower will also enable the banker to get a clear picture of his state of affairs.

Bazar Reports: Banks try to find out the creditworthiness of the party by making enquiries from the bankers, traders and businessmen in the same trade or industry. Their individual opinions may differ but a balanced opinion may be formed about the borrower on the basis of the feelings expressed by a number of such persons.

Exchange of Credit Information amongst Banks: It is the practice and customary usage amongst banks to exchange credit information relating to the constituents in their mutual interest. But, the credit reports exchanged by banks are brief and superficial. They are in general and guarded terms. Banks are reluctant to exchange meaningful credit information because they apprehend that legal protection available to them will be lost if more facts are divulged to the enquiring banks. A Study Group appointed by the Reserve Bank concluded that "the existing legal protection is adequate to permit banks to exchange meaningful credit information on their constituents." The Study Group, therefore, suggested that

★ there should be free and frank exchange of credit information amongst the banks and

* there should be qualitative change in the contents of credit reports, which should highlight the management practices of the customers, their behavioral pattern with their buyers, sellers and with the bank instead of concentrating entirely on the worth of assets and financial strength. Similarly, the customer's ability, business, acumen and integrity and willingness to honor commitments should also be covered in the Credit Reports.
* A central agency, to be called "Credit Information Trust", i.e., "CREDIT be established for organized collection, collation, storage and exchange of credit information amongst the banks.

Balance Sheet and Profit and Loss Account: An analysis of the Balance Sheet and Profit and Loss Account of the borrower for the last few years will reveal his true financial position. These statements should be certified by competent accountants.

17.7 FACTORS LIMITING THE LEVEL OF A BANK'S ADVANCES

The level of advances sanctioned by a banker depends upon the following:

The Size and Maturity wise Pattern of Deposits: The primary source of bank funds is the deposits made by the depositors. Their size and maturity wise pattern has an impact on the level of a bank's advances. Bank's capacity to grant loans and advances increases with an increase in deposit resources. Moreover, the maturity wise pattern of such deposits affects the pattern of advances. In case of demand liability, the banker is under an obligation to repay the funds on demand and hence he needs larger cash reserves. Thus, not only the amount of loans and advances is to be kept at a lower level but such loans should largely repayable on call or at short notice. On the other hand, if a larger portion of a bank's deposits is in the form of time deposits, not only the quantum of cash reserve maintained by it is reduced but it can lend the funds for relatively longer periods.

Credit Control by Reserve Bank: The capacity of banks to provide loans and advances depends on their cash resources (i.e. cash in hand and balances with the Reserve Bank). The cash resources increase through (i) rise in the deposits, or (ii) by their borrowing from the Reserve Bank, or (iii) by sale of their investments. The Reserve Bank regulates the quantum of cash resources of the banks by exercising the powers conferred upon it. If it feels the necessity of expansion of credit, measures are adopted to increase banks' cash resources and vice versa. The Bank Rate policy, the open market operations policy and the variable reserve requirements are the general or quantitative credit control measures which affect the level of banks' cash resources. The selective credit controls affect the level of bank credit against the specified commodities directly and immediately.

Seasonal Variations in Bank Credit: An important feature of bank credit in an agricultural country like ours is the seasonal variations in the quantum of credit granted by banks. The year is traditionally divided into two parts—the busy season and the slack season. The busy season (November to April) is characterized by higher demand for bank credit largely to finance the marketing and distribution of agricultural crops. The bank credit thus, reaches its peak during the busy season. During the slack season (May to October) bank credit contracts because of larger flow of funds to the banking system as a result of liquidation of stocks of agricultural produce. The seasonal variations in bank credit have been a well-known phenomenon in India since long but in recent years its significance has been reduced considerably. The slack season of 1970 was, for example, marked by virtual absence of any slackness in credit. In fact, the bank credit registered a sharp contra-seasonal expansion. This trend is due to a number of reasons, namely, larger expansion of bank credit against non-seasonal commodities and inadequate contraction of advances against seasonal commodities during slack season. Large expansion of advances to agriculture, small-scale industries, etc., is also responsible for this trend.

The Demand for Credit: The expansion or contraction of credit largely depends on the demand for bank credit by borrowers, which in turn depends upon:

- ★ The level of production, both agricultural and industrial;
- ★ The level of inventories held by business and industrial houses;
- ★ The price level of goods and commodities in the country.
- ★ The procurement policy of Food Corporation of India and other State agencies.

Check your progress – I

State whether true or false:

1) The customer withdraws money from the cash credit account as and when he needs. (True/False)
2) The banker can sacrifice safety for profitability while granting loans. (True/False)
3) Twenty major banks were nationalized to serve the nation better. (True/False)
4) The commitment charge will be imposed on the working capital limits sanctioned to sick units. (True/False)
5) Overdraft can also be inferred from the course of the business. (True/False)

17.8 CONSORTIUM ADVANCES

Commercial banks in India have started granting credit on a consortium basis for only to public food procurement agencies but also to various public and private-companies. The practice, also known as Participation Financing, or Joint Financing, is adopted in case of big borrowers, whose credit needs are met by two or more banks jointly in proportion to their capacities. There are two specific reasons for financing on participation basis; First, the resources of banks, do not permit large advances, particularly in view of the credit control measures adopted by the Reserve Bank; and second, the banks are able to diversify their risks by participating in big advances. Each bank bears a part of the risks involved in a large advance. Banks have in recent years adopted the concept of consortium advance not only in case of working capital financing but in term lending also. In the latter case, banks participate in term loans with the term lending institutions also and are benefited by the technical and other expertise of these institutions. The credit needs of public food procurement and distribution agencies such as the Food Corporation of India, State Governments, Civil Supplies Corporations and Co-operative Marketing Federations have been met by public sector banks and the major private sector Indian banks on consortium basis. Joint financing or consortium lending is to be distinguished from multiple banking. In the latter case a borrower borrows from a number of banks under separate agreements and securities are charged to them separately. But in case of a joint finance, an advance is given to the same party against a common security which remains charged to all the banks for the total advance. Usually, in the case of a consortium advance, one of the banks acts as a consortium leader and takes leading part in the processing of the loan proposal, its documentation, recovery, etc. The participating banks enter into an agreement setting out the terms and conditions of such participation arrangement.

RBI rules to the banks in regard to formation of consortium of banks for financing big borrowers relate to:

- ★ Number of participating banks,
- ★ Minimum share of each bank,
- ★ Entry/exit from the consortium,
- ★ Sanction of additional ad hoc limit in emergency situations/ contingencies by lead bank/other banks.
- ★ The fee to be charged by the lead bank for the service rendered by it.
- ★ Grant for any facility to the borrower by non-member bank.
- ★ Deciding the time frame for sanctions/renewals.

17.9 PARTICIPATION CERTIFICATES

The scheme of Participation Certificates is a scheme to even out liquidity amongst the banks, and certain other financial institutions. A participation certificate is an instrument through which a banker, who has granted credit to its borrowers, can share with other institutions having surplus funds, a part or whole of the credit given by it to its borrowers. Thus, the scheme facilitates inter-bank flow of funds for short periods, and reduces recourse to the Reserve Bank. Participation Certificates were first introduced in 1970 and gained prominence during the late 1970s. The Participation Certificates evolved the relationship of borrower and lender between the issuing bank and the purchaser bank/financial institutions. The certificates are issued only to scheduled commercial banks and are not transferable. Financial and investment institutions remain outside their purview. The salient features of the two types of Participations are as follows:

Inter-Bank Participations with Risk Sharing: The minimum period of such participations is 91 days and the maximum period 180 days. The rate of interest is determined by the issuing and participating banks. Banks will issue such Participations only in respect of advances classified under Health Code No. 1 status (i.e. advances to sound parties only). The aggregate amount of such Participations of any account should not exceed 40% of the outstanding amount in the account at the time of issue. If later on, the outstanding balance in such account fails short of the Participations outstanding, the issuing bank will reduce the Participations to the extent necessary. The issuing bank will normally repay the amount of Participations together with interest to the participant bank on the date of maturity. But, when the risk has materialized, the issuing bank will take necessary action in consultation with the participating bank and share the recoveries proportionally. The participating banks shall have to subscribe to the 'Uniform Code for Participations' which contains their mutual rights and obligations in relation to the securities.

Inter-Bank Participations without risk sharking: Such participations should be backed by Cash Credit Accounts of the borrowers. The maximum period of such participation will be 90 days. Rate of interest thereon will be determined by the two concerned banks. On the date of maturity, the issuing bank will pay the amount of Participations with interest to the participating banks, irrespective of the default, if any, in the advance concerned. The participations would be treated as part of the net demand and time liabilities and the net bank balances for purpose of statutory reserve requirements.

17.10 OTHER DIRECTIVE ON ADVANCES

Transfer of Borrower Accounts: The increase competition amongst the banks, the Reserve Bank has also permitted all parties (including those enjoying credit facilities in excess of Rs.5 crores) to transfer their accounts from one bank to another bank. There will be no need of a 'no objection' letter from the existing banker. The transferee bank will have to take over the entire liabilities of the party. If any industrial group maintaining more than one account with a bank seeks to transfer only good account, leaving an unsatisfactory account with the existing bank, the latter may refuse to allow such transfer unless satisfactory arrangements are made by the party.

Variation Clause in Loan Agreements: The schedule of interest rates on advances, prescribed by the Reserve Bank, is subject to changes made by it from time to time. To overcome the difficulty experienced by banks in implementing such changes in the interest rates, the Reserve Bank has directed commercial banks invariably to incorporate in loan agreements and other relevant documents the following proviso in the clause relating to interest rates:

"Provided that the interest payable by the borrower, shall be subject to the changes in the interest rates made by the Reserve Bank from time to time."

No Scrutiny of interest rates by courts: The banking laws (Amendment) Act, 1983 has inserted section 21-a in the Banking Regulation Act, 1949 which provides that the rates of interest charged by banking companies are not to be subjected to scrutiny by courts. According to the newly inserted section-

"Notwithstanding anything contained in the Usurious Loans Act, 1918 or any law relating to indebtedness in force in any state, a transaction between a banking company and its debtor shall not to be reopened by any court on the ground that the rate of interest charged by the banking company in respect of such transactions is excessive."

Clause prohibiting diversion of loan funds: Loans amounts must be actually utilized for the purpose for which they are taken. Some times the funds are diverted towards some other use and the advance becomes sticky. To avoid such a situation, the Reserve Bank has advised banks to include a clause in the loan documents prohibiting the borrowers from deflecting the loan amount to a purpose other than the one for which it has been sanctioned. The clause should confer the right on the bank to recall the loan amount or a part thereof if the bank apprehends that the borrower has violated or is violating this condition.

17.11 COMMERCIAL PAPER

Commercial paper is an additional source of raising short term funds by highly rated corporate borrowers. The Reserve Bank of India has issued guidelines

for this purpose. These guidelines, as amended in October 2000, provide as follows:

Eligibility: Reserve Bank of India has permitted primary dealers, satellite dealers and All India Financial Institutions also, besides the corporates to issue commercial paper. For the corporates the present eligibility conditions are:

- ★ The tangible net worth should be Rs.4 crores.
- ★ It should have a sanctioned working capital limit from a bank or a financial institution, and
- ★ The borrower account is standard asset.

Rating Requirement: The minimum credit rating of the commercial paper should be P-2 of CRISIL or equivalent rating by other approved agencies.

Maturity: The minimum period of maturity shall be 15 days and the maximum up to 1 years.

Denomination: Commercial paper may be issued for a minimum amount of Rs. 5 lakhs and thereafter in its multiples.

Investors: Commercial Paper may be held by individuals, banks, corporate, and incorporated bodies, Non resident Indians and Foreign Financial Institutions.

Mode of Issuance: Commercial Paper can be issued as a promissory note or in a dematerialized form. Underwriting is not permitted.

Issuing and Paying Agent: Only a scheduled bank can act as such agent.

Limits and Amount: Commercial Paper can be issued as a "Stand Alone" product. Banks and Financial Institutions will have the flexibility to fix working capital limits duly taking into the account the resource pattern of company's financing including Commercial paper.

Issue: Commercial Papers will be issued at a discount to face value and the discount rate will be freely determined by the issuing company. Commercial Papers will be freely transferable.

The issuing company will have to bear dealers' fees, rating agencies fees, standby facility charges and any other relevant charges.

Guarantee for credit enhancement: Credit enhancement for Commercial paper means that the credit worthiness of a commercial is increased by the guarantee given by a third party. In its credit policy of April 29, 2003, Reserve Bank of India permitted that non-bank entity including corporates may provide unconditional irrevocable guarantee for credit enhancement for Commercial paper issue provided the following conditions are fulfilled:

- ★ The issuer fulfills the eligibility criteria prescribed for issuance of Commercial paper.

- ★ The guarantor has a credit rating at least one notch higher than the issuer by an approved credit rating agency and
- ★ The offer document for Commercial Paper properly discloses the net worth of the guarantor company, the names of the company to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be revoked.

17.12 INTEREST RATES FOR ADVANCES FOR SCHEDULED COMMERCIAL BANKS

The interest rates on advances granted by scheduled commercial banks were prescribed by Reserve Bank of India and revised by it from time to time. With effect from October18, 1994 Reserve Bank of India abolished the minimum lending rates for advances over Rs. 2 lakhs and permitted the banks to fix their own prime lending rate which served as a minimum lending rate. Concessional rate of interest for advances up to Rs. 2 lakhs were prescribed by the Reserve Bank of India; 12% for advances upto Rs.25,000/- and 13.5% for advances exceeding Rs.25,000/- and upto Rs.2 lakhs. On October 22, 1997 the rate was changed to not exceeding 13.5%.

In October 1999, Reserve Bank of India permitted the banks to charge interest rates without reference to the prime lending rates in respect of the following categories.

- ★ Loans covered by refinancing schemes of term lending institutions.
- ★ Lending to the intermediary agencies
- ★ Discounting of bills and
- ★ Advances/over drafts against domestic/NRE/SCNR Deposits.

In April 2001, Reserve Bank of India permitted the banks to grant all types of loans at fixed rate. Now, banks have the freedom to offer all loans on fixed or floating rate basis. But, banks have to follow PLR stipulations. Small loans up to Rs.2 lakhs shall carry interest rates not exceeding the prime lending rate of relevant maturity.

17.13 INTEREST ON LOANS AT MONTHLY RESTS

During the year 2002-2003, Reserve Bank of India has permitted the banks to charge interest on advances at monthly rests. Interest on monthly rests shall be applied to all running accounts (e.g. cash credit, overdraft, export packing credit), all new and existing term loans and other loans of longer/fixed tenor. In case of agricultural advances, the existing practice of charging interest linked to crop seasons will continue. For changing the system to monthly rests, bank may obtain consent letters/supplemental agreements from the borrowers.

Check your progress - II

Fill in the blanks:

1. When a loan is granted for buying capital assets and for working capital purposes is called_____________________.
2. _______________advances must be made on the security of tangible assets.
3. Advances covered by guarantee given by third parties is called _____________.
4. The busy season in a year are ________________.

Let us sum up

There are three cardinal principles of bank lending, they are safety, liquidity and profitability. Banking institutions must ensure that loans are granted for productive purposes and serve national policies and objectives. The three different types of credits are Cash Credit System, Overdraft System, Loan System and Purchasing and Discounting of Bills. Each system has its own merits and demerits. The loan system can further be classified as short term loans, term loans, bridge loans, composite loans and consumption loans. The loan made on security of tangible assets are known as secured loans. When a charge on such assets is not offered in favor of the banker is called unsecured loan. The loans and advances covered by guarantees given by third parties are known as guaranteed loans.

The creditworthiness of the borrower is judged by the banker on the basis of character, capacity and capital. Creditworthiness of a person is assessed for a specified amount only. The credit information is collected from the borrower himself, RBI, other banks, bazaar reports and from a central agency called Credit Information Trust.

The bank advances are limited to the borrower based on the size and maturity wise pattern of deposits, credit control by Reserve Bank, seasonal variation in bank credit and the demand for credit. In the recent years, the banks are adopting joint financing or consortium advances to borrowers. Participation certificates are also becoming popular among commercial banks to even out liquidity between the banks and financial institutions. Commercial Papers is also an additional source of funds for the highly rated corporate borrowers from the commercial banks. The bankers charge interest on monthly basis and follow time lending stipulations issued by Reserve Bank.

Glossary

Cash Credit : A cash credit is an arrangement by which a banker allows a customer to borrow money up

to certain money against either a bond of credit by one or more sureties or certain other securities.

Commitment Charge : To avoid the loss caused to the banks by the non-utilization of cash credit limit to the full extent, a charge known as the commitment charge is made by the banks.

Bridge Loans : Bridge loans are essentially short term loans which are granted to industrial undertakings to meet their urgent and essential needs during the period when formalities for availing of the term loans sanctioned by financial institutions are being fulfilled or necessary steps are being taken to raise the funds from the capital market

Commercial Paper : Commercial paper is an additional source of raising short term funds by highly rated corporate borrowers.

Participation Certificates: A participation certificate is an instrument through which a banker, who has granted credit to its borrowers, can share with other institutions having surplus funds, a part or whole of the credit given by it to its borrowers

Answers to check your progress

Check your progress - 1

1. True, 2. False, 3. True, 4. False, 5. True

Check your progress - 2

1. Composite.
2. Secured
3. Guaranteed advances
4. November to April

Model Questions

1. Explain the general principles which guide the banker is making loans and advances.
2. Write short notes on Participation Certificates and Commitment Charge.
3. What are the different forms of bank advances?
4. "The fundamental principles on which credit are generally based are Character, Capacity and Capital " Explain.

Unit 18

MODES OF CREATING CHARGE

STRUCTURE

Overview
Learning Objectives
18.1 Lien
18.2 Pledge
18.3 Hypothecation
18.4 Mortgage
18.5 Assignment
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

Secured advances are those advances which provide absolute safety to the banker by means of a charge created on tangible assets of the borrower in favor of the banker. In such cases, the bankers get certain rights in the tangible assets over which a charge is created. There are several modes of creating a charge, e.g. Lien, Pledge, Hypothecation and Mortgage. The present chapter deals with legal provisions regarding the modes of creating charge over the tangible assets and the rights and obligations of various parties.

LEARNING OBJECTIVES

Section 171 of the Indian Contract Act confers the right of general lien on the banker. This chapter explains the modes of creating charge for secured advances and the rights of various parties. The various modes explained here in are:

- Lien
- Pledge
- Hypothecation, and
- Mortgage

The unit referred to in this part of the chapter are the sections of the Indian Contract Act, 1872

18.1 LEIN

The banker is empowered to retain all securities of the customer, in respect of the general balance due from him. The ownership of such securities is not

transferred from the customer to the banker. The latter gets the right to lien is considered tantamount to an implied pledge and he gets the right to sell securities retain the securities handed over to him in his capacity as a banker. A banker's in certain circumstances. A Lien can also be a Negative Lien. Under the negative lien, the banker does not get the right to retain any asset of the borrower. The borrower gives a declaration to the banker that his assets mentioned therein are free from any charge or encumbrance.

Lien can be of two kinds – particular lien and general lien. A particular lien is the right of a person to retain the goods or property on which the debt has arisen. The general lien is the right of a person to retain the goods or property for any balance due under a general balance of account. The general lien cannot be applied for the following types of transactions:

- ★ Securities or valuables deposited merely for safe custody
- ★ Trust money not the property of the customer
- ★ Title deeds casually left with the banker after a refusal by him to advance money on them.
- ★ Where a partner has deposited a lease to secure a particular advance to the firm.

18.2 PLEDGE

Section 172 of the Indian ContractAct, 1872 defines 'Pledge' as "Bailment of goods as security for payment of a debt or performance of a promise". The person who offers the security is called the "Pawner" or "Pledger" and the Bailee is called the "Pawnee" or the "Pledgee". Thus in case of a pledge:

- ★ there should be a bailment of goods; and
- ★ the objective of such bailment should be to hold the goods as security for the payment of a debt or the performance of a promise.

(i) Bailment of Goods: Section 148 defines bailment as the "delivery of goods from one person to another for some purpose upon the contract that the goods be return back when the purpose is accomplished or otherwise disposed of according to the instructions of the bailor". There are two important requisites of a bailment, they are:

Delivery of goods is essential for a contract of bailment. Delivery may be either physical delivery or constructive (or symbolic) delivery. Physical transfer of goods from the custody of the bailor to that of the bailee is not necessary. There may be constructive or symbolic delivery, which means anything having the legal effects of putting the goods in possession of the bailee or any person authorized by him. If the warehouseman in the possession of the goods is authorized to hold the goods on behalf of the bailee and he accepts it, the transfer of possession will be deemed to be complete. This is called delivery

by attornment. But distinction should be made between a mere custody of goods and procession which may be called judicial possession. Goods might be in the custody of a servant or a guest but they do no hold the possession of the goods.

Return of goods is essential. The bailee should return the same goods to the bailor or dispose them off according to his instructions after the purpose for which goods were delivered is fulfilled. The deposit of money in a bank account is not bailment, because,

(i) "money" is not "goods" , and

(ii) the banker is under no obligation to return the same currency notes.

(ii) Bailment of security for payment of debt: It is essential that the bailment of the goods is done with object to secure the payment of a debt or the performance of promise. If the goods are left with the banker for safe custody or for any other purpose, does not constitute a pledge. Banks, therefore, take a declaration in case of pledge to safeguard their interests.

Goods can be pledged by any one who is in legal possession of the same, namely,

- ★ The owner of the goods himself.
- ★ The mercantile agent of the owner.
- ★ Joint-owner with the consent of the co-owner.
- ★ If a person obtains possession of the goods by fraud, misrepresentation, coercion or undue influence, such contract is void at the option of the lawful owner provided the following conditions are fulfilled:
- ★ The contract has not been rescinded before the contract of pledge is entered into.
- ★ The pledgee acts in good faith and without notice of the defective title of the pledger.
- ★ If a buyer leaves the goods or documents of title to goods after sale in the possession of the seller, the latter may make a valid pledge of the goods, provided the pledgee acts in good faith and he has no notice of the sale of goods to the buyer.
- ★ A pledgee can himself repledge the goods but such repledge will be valid only up to the extent of his interest in the goods pledged.

Rights of a Banker as a Pledgee

The pledgee has the right to retain the goods pledged for the payment of the debt or the performance of the promise and also for the amount of interest due on the debt and the necessary expenses incurred by him in connection

with the possession or for the preservation of the goods pledged (Section 173). This right is applicable only in case of particular debt for which the goods are pledged, in the absence of an agreement to the contrary (Section 174).

- ★ In case of default by the pledger to make payment of the debt, the pledgee has the right either-
- ★ To file a civil suit against the pledger for the amount due and retain the goods as a collateral security; or
- ★ To sell the goods pledged after giving the pledger reasonable notice of sale (Section 176).
- ★ The pledger is bound to disclose to the pledgee the faults, if any, in the goods pledged which are within his knowledge, and which materially interfere with the use to those goods or expose the pledgee to extraordinary risks.
- ★ If the title of the pledger to the goods pledged is defective and the pledgee suffers any loss due to this fact, the pledger shall be responsible for such loss.
- ★ If the pledgee has given his consent as a result of inducement by fraud or misrepresentation in this regard or in regard to pledger's interest in the goods, the contract would be void at the option of the pledgee.
- ★ A pledgee's rights are not limited to his interest in the pledged goods but he would have all the remedies that the owner of the goods would have against a third person for deprivation of goods or injury to them.

Duties of the Pledgee

- ★ The pledgee is bound to return the goods on payment of the debt.
- ★ The pledgee is responsible to the pledger for any loss, destruction or deterioration of the goods, if the goods are not returned by the pledgee at the proper time (Section 161).
- ★ The pledgee is bound to use the goods pledged according to the agreement between the two parties. If he violates any of the conditions of the pledge, the contract would be void at the option of the pledger.
- ★ The pledgee is bound to deliver to the pledger any increase of profit-which may have accrued from the goods bailed in the absence of an agreement to the contrary (Section 163).
- ★ The pledgee is bound to take as much care of the goods pledged as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quantity and value as the pledged goods (Section 151). If he has done so, he is not responsible for the loss, destruction or deterioration of the goods pledged (Section 152).

Check your progress - I

Fill in the blanks:

1. Charge is created by a banker only in respect of ________________.
2. The banker does not get the right to retain any asset of the borrower in ________________.
3. The two important requisites of a bailment are________________ and return of goods.
4. Bailment of goods as security for payment of a debt or performance of a promise is called ________________.
5. The Indian Contract Act confers the right of ________________ on the banker.

18.3 HYPOTHECATION

In case of hypothecation, which is another method of creating a charge over the movable assets, neither ownership nor possession of goods is transferred to the creditor but an equitable charge is created in favor of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so. The charge of hypothecation is thus converted into that of a pledge and the banker or the hypothecatee enjoys the powers and rights of a pledgee. Hypothecation is a convenient device to create a charge over the movable assets in circumstances in which transfer of possession is either inconvenient or impracticable.

Precautions to be taken by Banker: The position of the banker under hypothecation is not as safe as under a pledge. If the borrower fails to give possession of the goods hypothecated, or sells the entire stock or borrows from another banker on the security of the same goods the banker shall have to resort to legal proceedings in a Court of Law for the recovery of the amount lent. The advances on hypothecation basis are as risky as clean advances. The banker should, therefore, take the following precautions to safeguard his own position:

★ The facility of loans on the basis of hypothecation of goods should be sanctioned only to person or business houses of high reputation and should financial standing.

★ The banker must periodically inspect the hypothecated goods and the account books of the borrower should be checked to ascertain the position of stocks under hypothecation. Care should be taken to see that unsaleable stocks are not being maintained by the borrower.

★ The borrower should be asked to submit a statement of stocks periodically giving correct position about the stocks and its valuation

and declaration that the borrower possesses clear title to the same.

- ★ Stocks should be fully insured against fire and other risks.
- ★ A name plate of the bank, mentioning that the stocks are hypothecated to it, must be displayed at a prominent place in the business premises of the borrower for public notice. This is essential to avoid the risk of a second charge being created on the same stocks.
- ★ In case the borrowing concern is a joint stock company, the charge of hypothecation must be registered with the Registrar of Companies under Section 125 of the Companies Act 1956, within a period of 30 days from its creation. The company should also give an undertaking not to create another charge over the same goods. This undertaking should also be registered with the Registrar and a collateral security in the form of a personal guarantee of a director may also be secured.

Guidelines issued by Reserve Bank of India against Risk of Double Financing. In case of hypothecation of stocks the same stocks maybe hypothecated to more than one bank.

The Reserve Bank of India felt this type of double financing as undesirable and advised the banks to observe the following precautions in this regard:

Before sanctioning any credit limit, the bank should ensure that the applicant is not enjoying similar facilities with other banks. In case he is having credit facilities from any other bank/banks, detailed information should be called for by the bank from those banks. As far as possible, parties should be advised to restrict their borrowings to only one bank.

The bank should obtain from the borrower a written application accompanied by a declaration about the existing credit arrangements and an undertaking that the stocks will not be hypothecated to any other bank without the prior approval of the bank. The undertaking should also be incorporated in the stock statements which the borrower is required to submit to the bank periodically. The terms of transaction should also stipulate that the advance will be recalled forthwith in case it is subsequently found that he had made a false statement in this regard.

Before granting credit facilities to the party, an office of the bank should inspect the stocks with a view to ensuring that the same stocks have not been hypothecated to other banks. He should record such information in his report relating to his periodical inspection.

In case the borrower is allowed to avail himself of credit facilities against hypothecation of stocks from various banks, it should be ensured that such stocks are segregated or demarcated in different godowns/shops and the same are properly recorded in separate stock books so as to facilitate easy verification by the bank officials.

18.4 MORTGAGE

Section 58 of the Transfer of Property Act 1882, defines mortgage as "the transfer of an interest in specific immovable property for the purpose of securing the payment of money, advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability". The tranferor is called 'mortgagor', the tranferee 'mortgagee'; the principal money and interest thereon, the payment of which is secured are called the 'mortgage money' and instrument, if any, by which the transfer is effected is called a 'mortgage deed'.

The main characteristics of mortgage are as follows:

- ★ A mortgage is the transfer of an interest in the specific immovable property and differs from sale wherein the ownership of the property is transferred.
- ★ If there are more than one co-owners of an immovable property, every co-owner is entitled to mortgage his share in the property.
- ★ The property intended to be mortgaged must be specific.
- ★ The object of transfer of interest in the property must be to secure a loan or to ensure the performance of an engagement which results in monetary obligation.
- ★ The actual possession of the property need not always be transferred to the mortgagee.
- ★ The mortgagee gets, subject to the terms of the mortgage deed and the provisions of the Transfer of Property Act, 1882, the right to recover the amount of the loan out of the sale proceeds of the mortgaged property.
- ★ The interest in the mortgaged property is reconvened to the mortgagee on the repayment of the amount of the loan along with interest thereon.

Forms of Mortgages

Simple Mortgage: In case of a simple mortgage the mortgagor binds himself personally to pay the mortgage money. He does not give possession of property but agrees, expressly or impliedly, that if he fails to pay according to his contract, the mortgagee shall have a right to cause the mortgaged property to be sold and the proceeds of sale to be applied in payment of the mortgage money to the extent necessary. As the possession over the property remains with the mortgagor, such mortgage is called non-possessory. The mortgagor takes upon himself a personal obligation to repay the amount failing which the mortgagee gets two options:

- ★ to apply to the Court for permission to sell the mortgaged property, or
- ★ to file a suit for recovery of the whole amount without selling the property.

Mortgage by Conditional Sale: Under this form of mortgage, the mortgagor ostensibly sells the mortgaged property with any one of the following conditions:

- ★ That the sale shall become absolute if the mortgagor fails to pay the mortgage money on a certain date.
- ★ That the sale shall become void if the mortgagor pays the mortgage money.
- ★ That the buyer shall transfer the property to the seller. If the latter makes payment of the mortgage money on a certain date.

Usufructuary Mortgage: In case of usufructuary mortgage the mortgagor gives possession of the property or binds himself, either expressly or by implication, to give such possession to the mortgagee. The mortgagee is authorized to retain his possession over the property until the payment of the mortgage money is made and to receive rents and profits accruing from the property and to appropriate the same in lieu of interest or in payment of the mortgage money or in both.

The chief characteristic of usufructuary mortgage is the transfer of the possession over the mortgaged property to the mortgagee, who is entitled to receive income accruing there from and to appropriate the same towards the payment of the mortgage money and/or interest thereon. The liability of the mortgagor is thus gradually reduced.

English Mortgage: In case of English Mortgage, the mortgagor binds himself to repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee on the condition that the mortgagee will retransfer the same to the mortgagor upon payment of the mortgage money. The mortgagee under an English mortgage is entitled to immediate possession and to retain possession until he is repaid. Thus the mortgagor-incurs personal liability to pay, and in addition transfers the mortgaged property absolutely, i.e. with all the interests and rights in the property.

Equitable Mortgage: Where a debtor delivers to the creditor or his agent documents of the title to immovable property with intent to create a security thereon, the transaction is called a mortgage by deposit of title deeds. The Act restricts such mortgage by deposit of the deeds to the towns of Calcutta, Madras and Bombay and any other town which the State Government concerned may specify in this behalf.

Anomalous Mortgage: A mortgage which is not a simple mortgage, a mortgage by conditional sale, a usufructuary mortgage, an English mortgage or an equitable mortgage within the meaning of Section 58 is called an anomalous mortgage. It means that if the terms and conditions agreed to between the mortgagor and the mortgagee do not strictly conform to those specified under Section 58 for the above types of mortgages and there is

even a slight variation from the same. The mortgage falls in the category of anomalous mortgage. In case of an anomalous mortgage the rights and liability of the parties are determined by their contract as evidenced in the mortgage deed and if such contract does not exist, by the local usage (Section 98).

Legal Mortgage vs Equitable Mortgage

From the point of view of transfer of the title to the mortgaged property, mortgages are divided into two categories: legal mortgage and equitable mortgage.

In case of legal mortgage, the mortgagor transfers legal title to the mortgaged property in favor of the mortgagee by a deed. In case of an equitable mortgage, the mortgagor transfers the documents of title to the mortgagee for the purpose of creating an equitable interest of the mortgagee in the property. It means that legal title to the property is not passed on the mortgagee, but the mortgagor undertakes, through a Memorandum of Deposit to execute a legal mortgage in case he fails to pay the mortgage money.

Chief merits of an equitable mortgage vis-à-vis legal mortgage are as follows:

★ Registration is not necessary. In case of equitable mortgage, the Memorandum of Deposit or the covering letter sent along with the title deeds need not be registered under the Indian Registration Act, 1908.

★ In the absence of registration, information regarding the mortgage remains confined to the banker and the customer. The reputation of the latter is not affected as a result of such mortgage.

★ On the repayment of the debt, the documents of title are returned back to the customer. The latter may re-deposit the same for effecting another mortgage. In case of legal mortgage a new deed is necessary at the time of every mortgage.

★ According to Section 96, the provisions which apply to a Simple Mortgage also apply to the mortgage by deposit of title deeds. The mortgagee thus gets the same rights as are conferred in case of a Simple Mortgage. An equitable mortgagee, therefore, stands on the same footing as a mortgagee by deposit of title deeds for the purpose of priority over the mortgaged property.

Risks in Equitable Mortgage

If the equitable mortgagee is negligent or misrepresents to another person, who advances money on the security of the mortgaged property, the right of the latter person will have first priority. The banker should be very careful in this regard and should not part with the documents of title in any case. If the

mortgagor desires to inspect or to show such documents to somebody else, he should be permitted to do so either in the bank premises or in the presence of the bank's lawyer. Equitable mortgagee should also make reasonable enquiries as to the possession of the property before accepting the title deeds. Under the Transfer of Property Act, 1882, the State Government can extend the facility of equitable mortgage to any town, they have been reluctant to do so as it may result in loss of revenue by way of stamp duty and registration fees. Fears of fraudulent transactions and litigation are also contributory factors.

Rights of a mortgagee

The rights of a mortgagee as specified in the Transfer of Property Act, 1882, are as follows:

- ★ Right to foreclosure of sale: The mortgagee has a right to obtain from the Court a decree that the mortgagor shall be absolutely debarred of his right to redeem the property or a decree that the property be sold. The former is called a suit for foreclosure. The right of foreclosure may be exercised by (i) a mortgagee by conditional sale, or (ii) a mortgagee under an anomalous mortgage, which authorizes the mortgagee to exercise such right. A usufructuary mortgagee or a mortgagee by conditional sale is not authorized to file a suit for sale.
- ★ Right to sue for mortgage money. Under Section 68, the mortgagee has a right to sue for the mortgage money in the following cases:
- ★ where the mortgagor binds himself to pay the money, or
- ★ where the mortgaged property is wholly or partially destroyed or the security is rendered insufficient and mortgagor has failed to provide further security to render the whole security sufficient, or
- ★ where the mortgagee is deprived of the whole or a part of his security by or in consequence of the wrongful act or default of the mortgagor, or
- ★ where the mortgagee being entitled to possession of the mortgaged property, the mortgagor fails to deliver the same to him.
- ★ Right of sale without the intervention of the Court. Under Section 69, the mortgagee has the power to sell the mortgaged property or a part thereof without the intervention of the Court in the following cases:
- ★ Where the mortgage is an English mortgage; and
- ★ Where the power of sale without the intervention of the Court is expressly conferred on the mortgagee by the mortgage deed and the mortgagee is the government or the mortgaged property or any part thereof was, on the date of the execution of the mortgage deed, situated within the

towns of Calcutta, Madras, Bombay or in any other town or area which the State Government may specify in this behalf.

- ★ The amount of sale proceeds of the mortgaged property shall be held by the mortgagee in trust and will be applied by him in the following order:
- ★ in payment of all costs, charges the expenses properly incurred by him in order to sell the property;
- ★ in discharge of the mortgage money and costs and other money, if any, due under the mortgage; and
- ★ the balance to be paid to the person entitled to the mortgaged property.
- ★ Right to the accession to mortgaged property, Section 70 enable the mortgagee to hold, for the purposes of security, any accession to the mortgaged property, which occurs after the date of the mortgage, if a contract to the contrary does not exist.
- ★ Right to sue and Right to realize the Security are distinct rights. A mortgagee possesses the right to sue the mortgagor and also to sue for the realization of his security. The mortgagee was not bound to sue for realization of his security in a suit to enforce the personal covenants of the mortgagor as the two claims arose out of distinct clauses of action.
- ★ Right in case of renewal of mortgaged lease. When the mortgaged property is a lease and the mortgagor obtains renewal of the lease, the mortgagee, in the absence of a contract to the contrary, shall, for the purposes of the security be entitled to the new lease (Section 71).
- ★ Right to recover money spent on mortgaged property. Under Section 72 a mortgagee may spend such money as is necessary for the following purposes and may add such money to the principal money, in the absence of a contract to the contrary. Interest on such money shall be payable by the mortgagor at the rate payable on the principal and, if no such rate is fixed, at the rate of 9% per annum:
- ★ for the preservation of the mortgaged property from destruction, forfeiture or sale;
- ★ for supporting the mortgagor's title to the property;
- ★ or making his own title thereto good against the mortgagor, and
- ★ for the renewal of the lease, if the mortgaged property is a renewable leasehold one.

Sub Mortgage:

The mortgagee may himself like to sub-mortgage the property mortgaged to him by the mortgagor. The banker should take the following precautions in this regard:

★ A notice should be given to the mortgagor who should be required to confirm the amount due from him to the mortgagee.

★ The banker should direct the mortgagor not to make payment to the mortgagee but to the bank, being the sub-mortgagee.

★ The banker should take the original mortgage deed and the title deed from the mortgagee.

★ The sub-mortgage shall be subject to the terms and conditions stipulated in the original mortgage deed entered into between the mortgagee and the mortgagor. The banker should therefore scrutinize these terms very carefully.

18.5 ASSIGNMENT

Assignment is another mode of providing security to the lending banker. Assignment means transfer of a right, property or a debt-existing or future. The borrower may assign any of his rights, properties or debts to the banker to secure a loan from the latter. The transferor is called the 'assignor' and the transferee the 'assignee'.

In banking business, a borrower may assign to the banker (i) the book debts, (ii) money due from Government department or semi-government organization, and (iii) life insurance policies.

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 - II

Fill in the blanks:

1. A charge created on noble asset is known as ______________.
2. When a customer offers immovable property like land and building as security for a loan, charge thereon is created by means of __________.
3. In the case of __________ mortgage, the mortgager gives possession of the property or binds himself either expressly or by implication to give such possession to the mortgagee.

4. The mortgager transfers __________ to the mortgages property in favour of the mortgagee by a deal in the case of a legal mortgage.
5. In an assignment, the transferor is called the ________________.

Let us sum up

Lien is a right possessed by a person to detain or retain the goods or property belonging to another, until he has received the due remuneration for the services he has rendered in respect of them. Lien can be particular lien or general lien. The general lien of a banker may be excluded by a contract to the contrary.

Pledge primarily involves delivery of goods by one person to another. Sometimes it could even be transfer of possession of documents of title to goods, not necessarily always the transfer of possession of goods. The person who pledges the goods is called the pledgor and the person receiving it is called the pledge. The pledge is valid if created by the owner or a mercantile agent. The banker has certain rights with respect to a pledge.

Hypothecation is a charge, which is preferred, when the property to be taken as security is movable. Hypothecation creates merely an equitable or notional charge on the property with the right of a banker to take possession of the property and sell the goods on default or a right to sue the owner to bring the property to sale and for realization of the amount due.

Mortgage is transfer of an interest in a specific immovable property. It can be created as a security for money advanced and for keeping up a promise.

Assignment is nothing but transfer of an optionable claim. It is the process by which one can transfer his right over his optionable claim to another. Optionable claim includes book debts, provident fund credit account, fixed deposit money, LIC policy, annuity, etc. Assignment is valid even if it is made without any valid consideration.

Glossary

Pledge : Bailment of goods as security for payment of a debt or performance of a promise.

Hypothecation : It is another method of creating a charge over the movable assets, neither ownership nor possession of goods is transferred to the creditor, but an equitable charge is created.

Mortgage : Transfer of an interest in specific immovable property for the purpose of securing the payment of money.

Assignment : It means transfer of a right, property or a debt, existing or future.

Answers to check your progress

Check your progress - I

1. tangible assets 2. negative lien 3. delivery of goods
4. pledge 5. general lien

Check your progress – II

1. hypothecation 2. mortgage 3. usufructuary
4. legal title 5. assignor

Model Questions

1. Define pledge. What are the rights and obligations of a pledger and pledgee?
2. Differentiate between equitable mortgage and legal mortgage.
3. Mention the salient features of different types of mortgage.
4. What is meant by charging of securities? Explain the various modes of charging the securities.
5. What is meant by negative lien?

Unit 19

ADVANCES AGAINST SECURED DOCUMENTS

STRUCTURE

Overview
Learning Objectives
19.1 General Principles of Secured advances
19.2 Advances against goods
19.3 Advances against documents of title to goods
19.4 Advances against stock exchange securities
19.5 Advances against Mutual Fund Units
19.6 Advances against Life Insurance Policies
19.7 Advances against Real Estates
19.8 Advances against fixed deposit receipts
19.9 Advances against Book Debts
19.10 Advances against Supply Bills
19.11 Advances against Gold Ornaments and Jewellery
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

While advancing against securities, the banker has to bear in mind that the security should be such that they confirm to the "MAST" principle – marketable, ascertainable, stable and transferable. The banker when confronted by default with the repayment by the borrower, he has to proceed against the securities obtained and realize quickly the value of the securities by sale. The securities obtained by the banker can be classified into primary securities and collateral securities. In primary security bank finance is made for an asset, while a collateral security is obtained, in addition to the primary securities.

LEARNING OBJECTIVES

This unit highlights how the banker should evaluate the various classes of securities in the context of "MAST" principles. The objective of this Unit is to list the various types of securities against which lending is done by a banker. The precaution the banker has to take before and while enlisting securities is also covered in this Unit.

19.1 GENERAL PRINCIPLES OF SECURED ADVANCES

Adequacy of Margin: 'Margin' means the difference between the market value of the security and the amount to the advance granted against it. A banker always keeps an adequate margin because of the following reasons:

★ The market value of the securities is liable to fluctuations in future with the result that the banker's secured loans may turn into partly secured ones.

★ The liability of the borrower towards the banker increases gradually as interest accrues and other charges become payable by him.

The following factors determine the margin:

★ The amount of margin depends upon the likely fluctuations in the prices of the various commodities.

★ In case of shares of industrial concerns the financial position and reputation of the issuing undertaking is also taken into account.

★ Margins are fixed keeping in view the credit and reputation of the borrower-concern, i.e. a lower margin may be fixed for the borrower having first class reputation against the security of the same commodity.

★ The margin, determined at the time of sanctioning a advance, may be raised or reduced subsequently according to the variation in the prices of the securities.

★ In case of commodities which are subject to selective credit control of the Reserve Bank of India, margin are usually prescribed by the Reserve Bank of India from time to time.

Marketability of Securities: Advances are usually granted for short periods by the commercial banks because their deposit resources (except term deposits) are either repayable on demand or at short notice. If the customer defaults in making payment, the banker has to liquidate the security. It is, therefore, essential that the security offered by a borrower may be disposed of without loss of time and money. A banker should be very cautious in accepting assets which are not easily marketable.

Documentation: Documentation means that necessary documents, e.g., agreement of pledge or mortgage, etc. are prepared and signed by the borrower at the time of securing a loan from the bank. Though it is not necessary under the law to have such agreements in writing and mere deposit of goods or securities will be sufficient to constitute a charge over them, but it is highly desirable to get the documents signed by the borrower. These documents contain all the terms and conditions on which a loan is sanctioned by the banker and hence any misunderstanding or dispute later on may easily be avoided.

Realization of the Advance: If the borrower defaults in making payment on the specified date, the banker may realize his debt from the sale proceeds of the securities pledged to him. as noted in the previous chapter, a pledgee may sell the securities by giving proper notice to the pledger of his intention to sell the securities.

19.2 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

An evaluation of goods and commodities as security to the banker reveals the following:

- ★ Safety
- ★ Price Stability
- ★ Easy Marketability
- ★ Shorter Duration of Advances

The banker should take the following precautions before accepting goods as securities:

- ★ Though the goods and commodities are the best securities to a banker for granting loans, the customer is also equally important.
- ★ Before accepting any commodity as security the banker must be well acquainted with the nature of its demand.
- ★ The banker must be well acquainted with the commodity market.
- ★ The banker should take delivery of the goods.
- ★ The banker should estimate the value of the goods very carefully.
- ★ The banker should also take necessary care regarding the storage of the goods pledged.
- ★ The goods should be duly and adequately insured against fire, theft etc.,
- ★ As the borrower is allowed by the banker to repay the loan in parts also and to get the commodities released, it is important for the banker to ensure that goods released be in proportion to the amount of the loan repaid by the customer

19.3 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. 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. There are two tests by which we may judge the validity of such a document:

★ The person who possesses such document is recognized by law or by business practice as possessing the actual goods; and

★ The person who possesses such document can transfer the goods to any person by endorsement or delivery or by both. The transferee is thus entitled to take delivery of the goods in his own right.

Bill of Lading, Dock Warrants, Warehouse-keeper's or wharfinger's certificate, railway receipts and delivery orders are the instances of the documents of title to goods.

Risks in case of Advances against Documents

Greater Risk of Frauds and Dishonesty: The transporter or warehouseman grants a receipt for the goods entrusted to him but he does not certify or guarantee the correctness of the contents of the bags or the packages. A dishonest trader may deceive the banker by giving false description of the goods in the documents of title which are pledged with the banker.

Not Negotiable Documents:. The documents of title to goods are not negotiable instruments like cheques, bills of exchange or promissory notes. The documents of title to goods are however, transferable ones and can be endorsed to any person but the transferee does not get a better title than the transferor.

Borrower's talking delivery: In case of railway receipt there is the risk of the borrower's taking delivery of the goods on the basis of an indemnity Bond, while the railway receipt is given to the banker as security.

Precautions to be taken by the Buyer

★ In order to avoid risks of fraud and dishonesty, the banker should accept such documents as security from honest, reliable and trusted parties only.

★ Special care should be taken to see that documents are genuine and not forged ones.

★ It should be carefully noted that the documents of title do not contain any onerous or prejudicial remark about packing of the goods. If the document contains a remark to this effect, such as "Packing Defective"

or "goods not properly packed" or "the container leaking", the banker should not grant any advance against such receipt.

★ The goods must be insured for its full value against the risks of fire, theft etc.,

★ To ensure that the goods packed in bags, etc., actually conform to the description contained in the documents, it is desirable that a certificate from a reliable firm of packers is obtained, especially in case of valuable goods.

★ The banker should also take a memorandum of charge from the borrower authorizing the banker to sell the goods if the borrower defaults in making payment.

★ It is also essential that the issuer of the document of title to goods, i.e., transporter, warehouseman etc., is a reliable person or firm.

Important Documents of Title to Goods

1. Bill of Lading

A Bill of Lading is a document issued by a shipping company acknowledging 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 prima facie 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 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 to demand all the three copies of the bill of lading duly endorse, before an advance is made against it.

A bill of lading is not a negotiable instrument, though it is transferable by endorsement and delivery. Therefore, a bonafide holder for value of such a bill of lading does not get title to the goods better than that of the transferor of the documents. He can sue in his own name and can give valid discharge.

2. Warehouse Receipts

An important objective promoting warehousing in the country has been to enable the owners of commodities-agriculturists and traders—to acquire a convenient security in the form of warehouse receipt, which can be accepted as security by the banks. The Precautions to be taken by the Banker while granting advances are as follows:

- ★ A Warehouse Receipt is not a negotiable instrument under the Negotiable Instruments Act and hence the transferee (i.e., the banker) cannot acquire title better than that of the transferor.
- ★ The banker should ensure that the Warehouse Receipt is a genuine one. The signatures of the Warehouseman and the endorsee, if any, should also be confirmed.
- ★ The Receipt should be pledged with the banker with a memorandum of pledge.
- ★ The banker should inform the warehouseman about his lien over the Receipt and the latter's acknowledgement be secured by the banker.
- ★ An additional undertaking should also be taken from the customer that he will not take delivery of the goods on the basis of Indemnity Bond. He should also inform the warehouseman not to release the goods without the consent of the banker.
- ★ The banker should release the Receipt on payment of the debt. If in the meanwhile a part of the goods is to be released to the customer, the banker should issue a delivery order.

3. Railway Receipt

Railway Receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is 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 receipt are for very short periods. The banker should take the following precautions in this connection:

- ★ The consignor may give wrong description of the goods consigned. The banker should, therefore, discount only such documentary bills with Railway Receipt which are drawn by parties of repute.
- ★ Sometimes the goods are delivered by the railway authorities on the basis of Indemnity Bond furnished by a wrong party. In such circumstances, the banker shall have to file a suit in the court of law. To avoid such a situation, the banker should inform the railway authorities at the destination about his interest in the goods and ask

them not to release the goods without the railway receipt duly discharged.

★ The railway receipt should be on railway risk and without any alterations. The banker should prefer "Freight Paid" railway receipt because he will not be required to pay the freight, if he is forced to take the delivery of the goods at the destination.

4. Trust Receipts

The goods or the documents of title to goods pledged with a banker as security for 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 customers to get back the goods or documents and ask the latter to execute a Trust Receipt.

19.4 ADVANCES AGAINST STOCK EXCHANGE SECURITIES

The securities dealt with on the stock exchanges are as follows:

★ Securities issued by the Central and State Governments.

★ Securities issued by semi-Government institutions like the Port Trust, Improvement Trust etc.

★ Shares of Joint Stock Companies.

★ Debentures of Joint Stock Companies.

Merits of Stock Exchange Securities

1. Security: Though the stock exchange securities are paper documents, they are treated as tangible assets because of their easy marketability. Government and semi-Government securities are rated high because of utmost confidence of the people in the Government and institutions sponsored by the Government. The prices of good securities do not fluctuate widely in normal times.

2. Liquidity: The stock exchanges provide a ready market for these securities. They can be disposed of more quickly and conveniently as compared to any other security. Government and semi-Government securities are called "Gift-edged securities" because of their steady market and stable prices. Moreover, the banker can re-pledge these securities with the Reserve Bank of India or any other banker to secure accommodation, if need arises.

3. Accrual of Income: The securities yield income by way of interest and dividend. The income received by the banker on such securities is adjusted towards the dues to be recovered from the customer and to that extent the latter's liability towards the banker is reduced.

4. Convenience: It is convenient for the banker to accept stock exchange securities because:

- ★ he can easily examine the title of the holder;
- ★ their market price can be easily ascertained by referring to the reliable quotations published in the papers/periodicals, etc.; and
- ★ their transfer to the banker can be effected more easily.

Government Securities

Government securities are the safest and easily realizable securities for bank advances. Their prices generally do not fluctuate widely and a ready market exists for them. Government securities may be issued as inscribed stock or promissory note

Government Promissory Notes

These promissory notes contains a promise on behalf of the President of India in case of Central Government Securities, or the Governor of the State concerned, in case of State Government Securities to pay the specified sum of money to the holder of the note (i.e., either the payee or the last endorsee whose name appears on the back) on a specified date or after a certain notice, subject to the terms and conditions of issue. The promissory note also contains the rate at which interest is payable half yearly. Government promissory notes are negotiable instruments.

National Savings Certificates. Banks are directed to prescribe a margin of 25% on the original investment in these certificates, without taking into account accrued interest. Thus, advance may be granted to the extent of 75% of the value of such certificates.

Kisan Vikas Patras

Commercial Banks are permitted to grant loans against the security of Kisan Vikas Patras. Banks should take into account the purpose of the loan and should follow the Reserve Bank of India direction on Interest rates. The Patras can be treated as main security. Margin is to be determined on the basis of the residual period for which the certificate is to run and other relevant factors.

Indira Vikas Patra

Advance against these patras can be granted after considering the purpose. Premature encashment of these patras is not allowed. Hence, margin may be determined by the banks depending upon the residual period for which the certificate is to run. The patras can be pledged in favor of the banks. No lien can be registered as the certificates are issued without registering the name of the purchaser. Banks should take utmost care for their safe custody, as they are freely transferable.

Corporate Securities

Preference Shares

Preference shares of a company are those shares which carry certain preferential rights for their holders over those of the equity share holders. Preference Shares carry a prescribed rate of dividend, which the company shall have to pay before any dividend can be distributed to the equity share holders. Preference shares may be either cumulative preference share or non-cumulative preference shares. In case of the former, if the company is unable to pay the prescribed dividend during any year/years, the same is payable out of the profit of the company in future years. The holders of non-cumulative preference shares do not enjoy this right. Again, the preference shares may be redeemable or non-redeemable. The former are repaid after a period specified therein.

Debentures

Debentures are generally secured by way of mortgage of immovable property of the company. The owners of such secured debentures are the secured creditors of the company. Unsecured debenture holders do not possess any such charge over the assets of the company. These debentures are usually redeemable ones; their redemption takes place after a stipulated period of time. Companies are now issuing debentures of 7 or 8 years maturity. The category of debentures that has become very popular amongst the Indian companies and the investing public over the last few years is that of convertible debentures.

Debentures with right attached

This is another type of debenture, which has no convertible part, but a right is attached thereto to subscribe to a certain number of shares of the company, after a certain period of time, at a low premium. The holder of such debentures gets a right to subscribe to the shares of company against cash payment at a future date. During recent years, the companies issuing the debenture have also offered other attractive terms as follows

★ Interest at the prescribed rate is payable on the application money right from the date of realization of application money.

★ No tax deducted at source from interest on debentures.

★ Debentures are redeemable at a premium of 5% i.e., each debenture of the face value of Rs.100/- will be redeemed at Rs.105/- at maturity.

★ The debenture holder is given an option to sell the debentures back to the company at par provided: (i) His total holding of debentures does not exceed the face value of Rs.40,000/- and , (ii) He has held the debentures continuously for at least one year.

- ★ The company will review interest rate if central government announces any increase in the rate of interest in respect of debentures, at any time during the currency of the debentures.

Banker's Preference: Usually, a banker prefers debentures of a company vis-à-vis shares because of the following reasons:

- ★ The status of a debenture of holder is that of a creditor of the company. There is a contractual obligation on the company to pay interest thereon regularly irrespective of adequacy of profits or the availability of cash at the relevant time.
- ★ Debenture holder happens to be a secured creditor of the company. Principal amount is to be paid on the due date. The assets mortgaged to the debenture holders provide absolute security to them.

The banking company is also prohibited from holding shares, whether as pledgee, mortgagee or absolute owner in any company in the management of which any managing director or manager of the banking company is in any manner concerned or interested. Banks cannot make loans or advances on the security of their own shares.

Risks in advances against shares

★ If the shares pledged by the borrower or partly paid up, the company makes calls thereon. The banker or his nominee, if registered as the owner of these shares in the company's books will be liable to make payment of such calls. Therefore, he should be very careful in accepting the partly paid up shares.

★ Generally, the Articles of Association of a company provide that the company will have right of lien on its shares, if a share holder fails to make payment of calls made by the company or of any other dues payable by him. The banker should, therefore, inform the company about his charge over the shares to safeguard his position.

★ In case of non-negotiable securities the banker cannot get title better than that of the transfer of such securities.

★ Some times share certificates were issued by companies in duplicate or triplicate on receipt of request from the shareholders. Banker should, therefore ensure the genuineness of the shares scripts.

Precautions to be taken by the banker

1. Selection of Shares: The suitability of shares as security for bank loan depends upon their price stability and easy marketability. Generally, they prepare a list of approved securities after they are satisfied as regards the following:

★ The nature of business means the type of business activity- manufacturing, mining, trading etc., carried on by the company; the significance of such activity in the national economy; the position of the company in that particular industry in the past; and the future prospects of the business of the company. If all these are quite favorable, the security rated high.

★ The success of an enterprise depends upon the competence of the management—technical, financial and managerial. If the directors, managing director and other top executives are competent, experience and honest persons enjoying good reputation in the commercial circles, the securities of such a concern are quite suitable security for a banker.

★ The banker forms his opinion about an enterprise on the basis of its financial results for the last few years. A study of the balance sheet and profit and loss account of the last few years enable the banker to anticipate its profitability in future years. The study of the balance sheet also reveals the position of the liquid assets in relation to current liabilities and that of reserves in relation to capital. The rates or dividend declared in the past should also be taken into account.

★ The study of movements in the share prices over a reasonable period is also essential. If the prices show a steady and regular tendency to raise, without frequent and sharp fluctuations, such security is rated high and preferred by the banker as security for an advance.

2. **Valuation of Securities:** The banker should ascertain their present market prices. Following precautions should be taken by the banker in this regard:

★ The prices quoted in daily news papers and financial periodicals should be consulted. In case of shares which are transacted very rarely, the banker should ask the secretary of the company to quote the price at which the last transaction took place.

★ Generally, the share prices are quoted cum-dividend, i.e., the buyer of security remains entitled to the current year/half-year's dividend. Therefore, the amount of such dividend should be deducted from the current market prices. After the closure of the books of the company for the transfer of shares, the dividend shall be paid to the owner whose name is registered with the company.

3. Creation of charge over securities:

Finally, a charge over the securities is created in favor of the banker and the title therein is passed on to the latter. A charge over the securities may be created in either of the two ways:

(i) Legal Title. Most of the securities transacted on the stock exchanges are registered stocks and shares. Their transfer must be registered in the books of the issuing companies. Thereafter the transferee acquires legal title to the securities.

(ii) Equitable Title: As an alternative to the transfer of legal title, equitable title may be transferred in favor of the banker by depositing the security with the latter without the registration of its transfer. The borrower deposits the securities with the banker and agrees, either expressly or impliedly, that the securities have been deposited with the aim to secure a debt taken from the bank. The transfer of securities to the banker is not registered in the books of the company. Equitable title is given to the banker in either of the two ways:

- **(a) By Memorandum of Deposit:** The banker takes a memorandum of deposit from a reliable borrower, specifying the purpose of such deposit so that no dispute may arise in future.
- **(b) By Blank Transfer:** When the customer deposits the securities together with the transfer forms signed by the transferor without specifying the name of the transferee and without mentioning the date, equitable title is created in favor of the banker.

Defects of Equitable Title

As the transfer of shares in case of equitable title is not registered with the company, equitable title created in favor of the banker may be defeated by a similar equitable title created earlier or by a legal title created subsequently.

issuing company may exercise the right of lien over the shares against the amount due from the registered share holders.

As the name of the banker having equitable title to the shares is not registered with the company he is not entitled to receive any notice regarding the issue of bonus or right shares or any other important information from the company.

Precautions to be taken by the Banker: The banker should take the following precautions while accepting the equitable title of securities:

Generally the shares standing in the name of the borrower himself should be accepted. If the shares in the name of the third party are offered as security, the banker should insist on the following: The third party must sign the transfer form in the presence of an official of the bank or a party well known to the bank.

A letter of renunciation should be taken from such party who authorizes the borrower to pledge the shares and also gives up his right in favor of the borrower.

The blank transfer forms must be sufficient in number, if the number of shares is large, so that they can be transferred conveniently.

The banker must send a letter to the company informing the latter about the charge over the shares being created in favor of the banker. It is very essential to safeguard the interests of the banker against – any prior charge over the shares and issue of duplicate copy of the share certificates.

The banker must retain the shares in his possession till the amount of the loan is repaid. If they are released to the borrower before the time, there is a possibility that he may transfer the legal title to any other person.

The borrower must be required to sign a memorandum authorizing the banker to sell the securities in case he defaults in making payment. It is essential that the banker exercises this right of sale after giving a notice demanding payment within a reasonable period.

The borrower should also authorize the company in writing to pay dividend, etc., to the banker, so that the latter collects the same to credit it to the borrower's account.

Advances against shares should be granted to those constituents who are in a position to pay up margins without delay, with the price of the shares falls sharply. Generally a margin of 50% is maintained.

Reserve Bank's Guidelines regarding advance against shares

While granting advances against shares, banks are required to follow the guidelines issued by the Reserve Bank of India in this regard. The main points contained in these guidelines are as follows:

Banks should strictly observe the statutory provisions in this regard contained in sections 19(2) and (3) and 20 (1a) of the Banking Regulations Act 1949.

Banks should exercise due caution and restraint in lending against shares and debentures. They should take into account the nature, purpose and need for such advances to ensure that the finance is not utilized for speculative purposes.

Advance against the primary security of shares and debentures should be kept separate from other advances and should not be combined with them.

Banks should be satisfied about the marketability of the shares/debentures. Net worth and working of the company issuing the shares/debentures should also be investigated.

Shares and debentures should be valued at the current market price.

Bank should maintain adequate and proper margin while granting advances.

Advances should not be granted against the security of partly paid up shares.

Where advances are sought against large blocks of shares by a borrower or a group of borrowers, banker should exercise particular care. They should ensure:

★ The borrower's ability to repay the advance and also

★ That the advance is not utilized for purposes other than short term productive purpose.

★ That the advance is not used to enable the borrower to acquire or retain a controlling interest in the company or to facilitate or retain inter-corporate investments.

It should also be ensured that a single borrower or a group of borrowers do not obtain large credit against shares/debentures from different banks.

Where the limit of advances granted to a borrower against shares/debentures exceed Rs.10 lakhs, the shares/debentures should be transferred in the bank's name.

In respect of those scripts which are held by the bank as security against advances granted to share and stock brokers (registered with the securities and exchange board of India and Members of recognized stock exchange), the period for getting the shares and debentures transferred in the bank's name shall be 9 months.

Advances above Rs.5 lakhs against shares and debentures should be sanctioned by the board/committee of directors.

Advances against the primary security of shares/debentures may be given to: Individuals, Investment Companies, Stock and Share brokers and Trust and Endowments.

Loans may be granted against shares and debentures to individuals for the following purposes: (i) for meeting contingencies and needs of personal nature or (ii) for subscribing to rights or new issues of shares and debentures and (iii) for the purchase of shares and debentures in the secondary market.

In case of investment companies, banks may grant advances of a bridging nature for a period up to 9 months to cover the gap between the current resources and their existing and proposed investments in shares/debentures.

Reasonable overdraft facilities against shares and debentures may be given to share and stock brokers, after making a careful assessment after requirements of their requirements for such finance.

In case of Trust and Endowments, banks can grant bridge loans up to 9 months for the purpose of fresh investment/subscriptions to rights issues.

In case of companies or industrial borrowers banks can grant advances to meet margin requirements for short periods up to 1 year against the collateral security of shares and debentures

Check your progress - I

State whether True or False:

1. Margin means the difference between the market value of the security and the amount to the advance granted against it.
2. A banker should be very cautious in accepting assets which are not marketable.
3. The documents of title to goods are not transferable but can be endorsed.
4. A bill of lading is a document issued by railway authorities
5. Commercial banks are not permitted to grant loans against Kissan Vikas Patra.
6. Preference shares carry a prescribed rate of dividend.

19.5 ADVANCES AGAINST MUTUAL FUND UNITS

Banks may also grant advances on the security of units of the mutual funds including those of the Unit Trust of India. Banks are required in particular to ensure that

★ The units are listed on the stock exchanges,

★ Units have completed the minimum locking period in the relevance scheme

★ The amount of advance should be linked to the net asset value or the market value of the units whichever is less and not to the face value.

★ The quantum of advance and margin requirement should be the same as are applicable in case of shares and debentures.

19.6 ADVANCES AGAINST LIFE INSURANCE POLICIES

A Life Insurance Policy is a contract between the insured and insurer wherein the latter promises to pay a specified amount after the expiry of a certain period or on the occurrence of death of assured. A Life Insurance Policy is deemed the suitable security by a banker because of the following merits:

★ The policy can legally be assigned to the banker. According to the terms and privileges of the life insurance policy, it can be assigned to anybody including a banker and such assignment is duly registered by the Insurance Company.

★ The policy has a guaranteed surrender value. The above mentioned assurance regarding the repayment of the loan is available to the banker at the time of death or when the policy matures.

★ As a Life Insurance Policy is handed over to the banker, after its assignment is registered in the books of the Insurance Company, the banker need not worry about the supervision of the security.

★ It is an easily realizable asset. Its value can be easily realized by the banker on the death of the customer. The formalities required to be undertaken by the banker are few and not difficult.

The drawbacks of the life insurance policies are listed below:

★ Life Insurance is a contract of utmost good faith. The Life Insurance Polices issued by the Insurance Company provide that the policy shall be void and all claims to any benefit shall cease and determine in the following cases:

- if it appears subsequently that any untrue on incorrect averment is contained in the proposal and the declaration or in the statements or
- if any of the matters have not been truly and fairly stated or that any material information has been withheld or
- if the premium are not duly paid

★ Under a contract of insurance, the insured promises to pay premium to the insurer at regular intervals failing which the policy lapses. The banker thus bares the risk arising out of the non payment of premium by the insured.

★ Life policies, some time contains some special conditions also. For example, a suicide clause may be incorporated therein to the effect that the policy shall become invalid if the assured commits suicide within a given initial period.

Precautions to be taken by the banker

★ **Existence of insurable interest:** A life insurance policy may be taken by a person on his own life or on the life of any other person. It is essential that the insured must have insurable interest in the life assured at the time of proposal; not necessarily at the time of maturity of the policy. Insurable interest means pecuniary or monetary interest in the life assured, that is the person securing the insurance policy will suffer monitory loss or hardships if the life assured expires. The banker must ascertain whether insurable interest existed at the time of policy was issued.

★ **Proof of age admitted by the insurer:** The Life Insurance Company requires proof of age of the life assured because the amount of premium depends upon the age of the assured. The banker should see that the age has been admitted by the insurance company on the basis of either the certificate of birth or the horoscope and the same has been properly recorded on the policy itself or by a separate letter.

★ **Preference for endowment polices:** The banker should prefer endowment polices as compared to the whole life policies because the former mature at a certain date or on the death of the assured, whichever is earlier.

★ **Ascertain the surrender value:** The banker should ascertain the surrender value of the policy from the insurance company before granting an advance.

★ **Creation of charge over the policy:** A charge over the policy in favor of the banker may be created in any one of the following two ways:

- **By assignment:** The assured assigns the policy in favor of the banker. Such assignment may be made on the policy itself or alternatively on a separate stamped paper.
- **By equitable mortgage:** The policy is deposited with the banker with a letter containing the mortgagor's promise to assign it to the banker at the latter's request. The banker should intimate the insurance company about the creation of an equitable assignment on the policy in his favor.

★ **Payment of premium:** The banker should ensure that the insured regularly pays the premium on the policy and should ask for the receipts issued by the insurance company for his own record.

19.7 ADVANCES AGAINST REAL ESTATES

Bankers reluctance to accept real estate as security is largely due to the following practical difficulties and legal complications:

Ascertaining the title of the owner: Before accepting the real estate as security, the banker must ascertain the title of the owner to the property to be mortgaged. This is a difficult task, because the laws are quite complicated. The banker, therefore, asks his solicitors to examine the documents of title to property to ascertain whether the borrower possesses the right to mortgage the property. It is also to be confirmed that the property is unencumbered. That is no prior charge exists, otherwise the second charge over the property in favor of the banker will have second priority. This is done by inspecting the register of mortgages for which necessary expenses are to be incurred and much time is spent. The problem of establishing the right of ownership is extremely difficult in case of agricultural land, because land records are not properly maintained.

Restrictive Laws: The commercial banks are placed at par with ordinary money lenders under the debt relief laws and other acts regulating money lending with the effect that they are also restricted from proceedings against defaulters, who are agriculturists. In some cases, the agriculturists are barred from transferring their land to the commercial banks. These restrictive laws limit the utility of land as a suitable security for the commercial banks. The Rural Credit Review Committee, therefore, recommended that those features of the legislation which inhibit the commercial banks from providing credit to agriculturists to be deleted by the State Governments.

Land and buildings are not readily realizable assets: These are, therefore, not preferred by the commercial banks. Because, of their obligation towards the depositors to repay the deposits on demand. Arranging the sale of land and buildings takes time as their demand is influenced by many factors. Sometimes, it is difficult to dispose them of quickly.

The valuation of a property is a difficult problem: If the banker accepts a building as security for a loan, he is naturally interested in the realizable value of the property and not its book value or its cost of construction. The total amount invested in a building by the customer might not be realizable if the property is offered for sale because of its location, special type of construction or lack of demand at a particular time.

Legal formalities: Preparation of mortgage deed and its registration takes time and expenses are incurred in the form of stamp duty, registration fee, etc., thus much cost is involved in creating a charge on real estates in favor of the banker.

Precautions to be taken by the banker

Financial soundness of the borrower: A prudent banker always scrutinizes the financial soundness of the borrower and the viability of his business enterprise for which a loan is to be advanced. He should be satisfied about the capacity and competence of the borrower to return the borrowed money from his own resources. Though, he is legally entitled to take recourse to the mortgaged property, a banker likes to avoid this and depends upon the financial soundness of the borrower.

Examination of the documents of title: The banker should refer the documents of title to property to his lawyer, to ascertain whether the mortgagor possesses absolute and undisputed title to the property and also the right to mortgage it. The banker and his lawyer should examine the abstract of title to find out the transfer of property in the past.

Investigation of prior charge over the property: It is also essential for the banker to ascertain whether the property, offered as security, is an encumbered and without having any previous charge in favor of any other party. The banker should, therefore, conduct search by a lawyer into the register mortgages and charges either since the purchase of the property by the mortgagor or for the last 20 years, whichever period is shorter.

Valuation of the property: Valuation of real estate must be undertaken by the banker very carefully. The following factors should be taken into consideration in this regard:

- For the purpose of the lending the realizable value of the property is relevant rather than its book value or its cost of construction.

- ❖ The value of real estate also depends upon the ownership right, i.e., whether it is freehold or leasehold.
- ❖ The prices at which similar properties have been transacted in the same locality in recent past is also a dependable guide as to the realizable value of the property in question, because real estate prices are influenced by the location of the property to a large extent.
- ❖ The value of the property also depends upon the size, structure, layout and construction.
- ❖ The market value is ascertained by capitalizing the rental value of the property at a reasonable rate of interest.

Sufficient margin to be maintained: As an immovable property is not an easily realizable security and its estimated value is just a guess work, banker should safeguard their interest by keeping sufficient margin. Banks generally keep margin ranging between 33% and 50% of the value of the property.

The property must be insured: The banker should insist that the building to be mortgaged must be insured against fire to the extent of its full value irrespective of the amount of the loan advanced. It is essential to safeguard the banker's interest because the average clause inserted in the fire insurance polices, make the insurance company responsible on a pro rata basis, if the property is under – insured.

Registration of legal mortgage: If the amount secured by a legal mortgage is Rs.100 or more the mortgage must be created by a registered mortgage deed. The banker should, therefore, insist on the registration of the mortgage deed.

19.8 ADVANCES AGAINST FIXED DEPOSIT RECEIPTS

A fixed deposit made by a depositor with a banker is repayable after the specified period is over. If, in the meanwhile, he is in urgent need of money he may taken advance from the banker on the security of the Fixed Deposit Receipt or alternatively he 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:

★ A Fixed Deposit Receipt issued by the same bank is the safest security for granting an advance. Because the receipt represents a debt due from the banker himself. Recently the Reserve Bank of India has, therefore, advised the banks that advances against the security of their own deposits may be excluded from the purview of exposure ceiling. A banker should not grant an advance on the security of a Fixed Deposit Receipt issued by another bank; the latter possesses its paramount lien over the receipt.

★ The banker should normally advance a loan to the same person or person in whose name/names the receipt is issued.

★ While handing over the receipt to the banker as security, all the depositors must discharge it by signing across a revenue stamp and must sign a memorandum of pledge. The banker is thereby authorized by the depositors to appropriate the amount of the Fixed Deposit Receipt towards the repayment of the advance taken from the banker.

★ According to the Reserve Bank of India directive a margin of not less than 25% is to be maintained by banks while granting loans against any deposit.

★ After sanctioning a loan the banker must make a note of the lien in his Fixed Deposit Receipt register and also on the receipt itself. In case the receipt is issued by another branch of the same bank, the latter must make the same note and verify the signature of the depositor and the fact that no prior lien exists. The lending branch should advance the money only after the above has been done by the other branch which has issued the receipt.

★ If the receipt stand in the name of a minor, the banker should not grant a loan.

★ In the past the Reserve Bank of India directed the banks that the interest chargeable on a loan against a Fixed Deposit Receipt was to be at least 2% points above the interest payable on such deposit, if the deposit was in the name of the borrower, either singly or jointly.

★ In April 1999, Reserve Bank of India decided that in case of deposit rate being in excess of prime lending rate advances to depositors against Fixed Deposits can be made by banks without reference to the ceiling of P.L.R.

★ The Reserve Bank of India has directed the banks that normally advances against third party deposits should not be encouraged.

★ On the date of maturity of the receipt, the bankers adjust the loan by the amount refundable to the customer. If the customer repays the loan before the due date of the receipt, the banker returns the receipt and cancels the discharge by the depositor and the note of lien thereon.

★ If the deposit receipt is issued by another branch of the same bank, the following additional precautions may be observed:

- ❖ The lending branch should ascertain from the other branch that it has not noted any lien against the said deposit receipt.
- ❖ The issuing branch should verify the discharge on the deposit receipt.
- ❖ After sanctioning the advance, the lending branch should inform the issuing branch to note its lien on the receipt.

- ❖ The borrower should write a letter to the issuing branch requesting it to send the amount of the receipt to the lending branch on the maturity of the receipt.

19.9 ADVANCES AGAINST BOOK DEBTS

Sometimes a customer of a banker may seek an advance on the security of his book debts which have either become due or will accrue due in the near future. In other words, the debt which the customer has to realize from his debtors is assigned to the banker. An actionable claim means a claim to any debt or any beneficial interest in movable property not in the possession of the claimant which the Civil Courts recognize as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent. A debt secured by mortgage of immovable property or by hypothecation or pledge of movable property is not included in actionable claim. The person who assigns an actionable claim is called the assignor and the person to whom it is assigned is called the assignee. Assignment of debt may be with or without consideration. The banker should take the following precautions while advancing a loan on the security of a book debt:

★ The banker must enquire into solvency of the party owing debt to the customer and also the validity of the debt.

★ The assignment of book debt must be effected by the execution of an instrument in writing, signed by the transferor or his duly authorized agent, clearly expressing his intention to pass on his interest in the debt to the assignee.

★ Notice of assignment must be served on the debtor by the banker. Though assignment is not rendered ineffective or invalid for want of such notice, it is essential so as to make the debtor liable to make payment to the assignee.

★ The banker should also take an undertaking from his customer to pass on to him the amount received by the customer from his debtor in the respect of the assigned debt.

★ After the assignment of the debt, all rights and remedies of the transferor, whether by way of damages or otherwise, shall vest in the transferee and the latter may use or institute proceedings for the same in his own name without obtaining the transferor's consent and without making him a party thereto.

★ The transferee of an actionable claim shall take it subject to all the liabilities and equities to which the transferor was subject in this respect at the date of the transfer.

19.10 ADVANCES AGAINST SUPPLY BILLS

Banks grant advances on the security of supply bills also. These bills are furnished by persons who supply goods, articles or materials to various departments of the Government or semi-Government bodies, companies, departments of the Governments etc., and by contractors who undertake Government contract works. The procedure followed in this regard is as follows:

★ The supplier dispatches the goods/materials by rail or road to the concerned departments and sends the Railway Receipt or other documents to the department directly and secures an Inspection Note or Certificate or Receipted Challan.

★ Similarly on the completion of the contract work or a part thereof, the contractor gets an Inspection Note from the concerned authorities' certifying the extent of the work done by him.

★ Thereafter the supplier or the contractor prepares his bill for the goods supplied /work completed and gives it to the bank for collection and seeks an advance against such bills. Payment of such bills by the purchaser is made on the expiry of an agreed period of time, say 30 to 90 days.

Risks in Advancing Loans against Supply Bills: The banker bears the following risks in granting loans against supply bills;

★ The collections of supply bills take time and there remains the possibility about undue delay in payment by the Government department due to procedural matters, etc.

★ Advances against supply bills are clean advances as no tangible security is offered to the banker. Sometimes, bills are not passed for payment for their full value and a deduction is made for the unsatisfactory quality of the goods supplied/work done.

★ The Government department has the right to set off any amount due from the supplier/contractor against the amount of the bill.

Precautions to be taken by the Banker

★ The banker should grant credit limits against supply bills to only honest suppliers/contractors having sufficient experience in the business concerned.

★ The banker should examine the contract entered into between the supplier and the Government department and scrutinize the terms and conditions to be complied with by the supplier for submitting his supply bill.

★ The supplier/contractor should be required to execute an irrevocable power of attorney in favor of the banker authorizing the banker to receive the amount of the bill directly from the purchase. The power of attorney should be filed with the Department.

★ The banker should take from the supplier a letter of authority addressed to the purchaser asking the latter—

- ❖ to send the proceeds of all the bills drawn on him—whether sent directly or through the bank—to the Bank named therein, and
- ❖ Not to make any adjustments in the amount of the bills in respect of any amount due to him form the supplier.

The supplier/contractor should also be required to give an undertaking to repay to the banker any amount received by him directly from the Department in respect of the bills entrusted to the banker for collection.

★ When supply bills are submitted to the banker, they should be scrutinized on the following points:

- ❖ The bills should conform to the delivery note or inspection note. The particulars of the goods supplied, as given in both the documents, must tally.
- ❖ The inspection note or delivery note should be duly signed by the purchaser or his authorized representative. The banker should, for this purpose, obtain the signatures of both the parties for his own record.
- ❖ The bill, delivery note or inspection note should not bear an old date. The banker should also certain that these documents are not the same which were returned back by the purchaser earlier.
- ❖ Banker should ascertain that the goods were dispatched against a firm order. There must be some proof of the dispatch of the goods, e.g., details of railway or lorry receipt, etc.
- ❖ The bill should be duly endorsed in favor of the banker.
- ❖ The amount of the bill should not be larger than the value of the goods supplied.
- ❖ Any amount received in advance by the supplier must be clearly shown in the invoice.

★ The banker should advance against supply bills keeping a margin of 10% to 25%. Banks charge their commission and other expenses separately.

★ When the banker receives advice regarding the realization of the supply bill, the amount is credited to the cash credit account of the customer.

★ If the supply bill is returned unpaid or if the purchaser has not paid the bill to its full extent the banker should ask the supplier to regularize the account, i.e., make its payment.

10.11 ADVANCES AGAINST GOLD ORNAMENTS AND JEWELLERY

Banks generally do not prefer gold ornaments and jewellery as security for advance for various reasons. However, Reserve Bank has permitted them to accept them for enabling the borrowers to meet their urgent medical expenses and other unforeseen liabilities. In August 1993 a ceiling on such advances was fixed at Rs.25, 000/-. But in February, 1995 banks were permitted to fix their own ceiling.

Check your progress - II

State whether True or False:

1. Advances against mutual fund unit should be linked to Net Asset Value (NAV).
2. The value of a property depends on size, structure and its layout.
3. A fixed deposit is made by the depositor with the banker and is repayable after specified period is over.
4. Supply bills are furnished by persons who supply goods.
5. From February 1995, the banks are permitted to fix their own ceiling to advance against gold ornaments.

Let us sum up

Advances against goods and commodities stand the test of safety, liquidity and profitability. Goods must be easily saleable and steady in price. Adequate margin on stocks as stipulated in the sanction letter should be maintained. A document of title to goods can be transferred by delivery, with or without endorsement and without any notice, to the person liable on it. Further, transferee of a document of title to goods can sue in his own name and give a valid discharge to the person liable. Bills of lading, warehouse receipts and railway receipts are some of the important documents of title to goods.

Advance against LIC policy can be given either by way of overdraft or loan. A banker should ensure the LIC premium is paid promptly. Fixed deposits are also eligible for advances from a banker. While advancing against security of immovable property, the banker should ensure that the property is easily saleable in case of default. The banker advancing against shares and debentures must adhere to the provision relating to the Banking Regulation Act and the guidelines issued by RBI from time to time. Advance against mutual funds should be based on Net Asset Value (NAV).

Advances against supply bills are unsecured, as the goods covered are already delivered to the drawee. These are financed by way of Over Draft, Cash Credit or Bill Discounting. Supply bills are just invoices, and hence not negotiable instruments. Therefore banker should take due care while advancing against

supply bills. Loans are also granted against gold ornaments. It should be ensured that gold ornaments are pledged by the owner himself and not by third parties.

Glossary

Margin : Margin means the difference between the market value of the security and the amount to the advance granted against it.

Insurable Interest : Insurable interest means pecuniary or monetary interest in the life assured, that is the person securing the insurance policy will suffer monitory loss or hardships if the life assured expires.

Railway Receipt : Railway Receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein.

Bill of Lading : A Bill of Lading is a document issued by a shipping company acknowledging the receipt of goods for carrying to a specified port.

Government Promissory Notes

These promissory notes contains a promise on behalf of the President of India in case of Central Government Securities, or the Governor of the State concerned, in case of State Government Securities to pay the specified sum of money to the holder of the note (i.e., either the payee or the last endorsee whose name appears on the back) on a specified date or after a certain notice, subject to the terms and conditions of issue.

Answers to check your progress

Check your progress - I

1. True 2. True 3. False 4. False 5. False 6. True

Check in progress - II

1. True 2. True 3. True 4. True 5. True

Model Questions

1. Explain the general principles of a secured advance.
2. What precaution should be taken by a banker while advancing against goods.
3. Write a short note on warehouse receipt and railway receipt.
4. What are the advantages of advancing against Stock-Exchange Securities? What precautions should be taken by a banker while advancing against shares ?
5. Write short note on Supply Bills.

Unit 20

PURCHASING AND DISCOUNTING OF BILLS

STRUCTURE

Overview
Learning Objectives
20.1 Discounting/Purchase Defined
20.2 Bill of Exchange
20.3 Discounting of Bills of exchange
20.4 Reasons for restricted use of bills in India
20.4.1 The system of Cash Credit and Running Accounts
20.4.2 Lack of Facilities for Rediscounting
20.4.3 High Rate of Stamp Duty
20.4.4 Absence of Adequate Public Warehouses
20.4.5 Small Number of Bank Offices
20.4.6 No Homogeneity of Customs Governing Hundies
20.5 Advantages of discounting of Bills by banks
20.6 Precautions in discounting bills
20.7 Liabilities of the Parties
20.8 Dishonor of Bills
20.9 Bill market Scheme
Let us sum up
Glossary
Answers to check your progress
Model Questions

OVERVIEW

One of the most common means of financing an international or national trade transaction has been with a bill of exchange. During the 18th and 19th centuries, this was the predominant method of granting bank accommodation. However, lately it has tended to decline because the cheque and mail transfers were becoming a convenient, popular means of internal payment. It is only in times of credit restriction that these appear to gain importance. Having analyzed cash credit, overdraft, and loan system in the earlier chapters, this unit describes the third style of credit that is -purchasing and discounting of bills.

LEARNING OBJECTIVES

The objective of this unit is to highlight the various issues relating to the Bills of Exchange. The following are discussed in this unit:

- Discounting/Purchase Defined
- Reasons for restricted use of bills in India:
- Advantages of discounting of Bills by banks:
- Precautions in discounting bills:
- Liabilities of the Parties
- Dishonor of Bills
- Bill market Scheme

20.1 DISCOUNTING/PURCHASE DEFINED

"To discount a bill is to buy it to become the transferee of it, by having it endorsed or transferred by delivery by the holder, giving him a price settled either by agreement or by the current rate in the money market, and based on the time the bill has to run." Discounting a bill, therefore, is taking a bill at once as transferee for value. It is in fact buying it or taking property in the instrument. Where the bill is negotiable by mere delivery, i.e., payable to bearer, the bank becomes a holder in due course by mere discounting the bill. But if the bill is payable to order, it can be negotiated only by endorsement and delivery. Without the endorsement of the customer, the bank will be merely a transferee for value, and not a holder in due course. While a usance or time bill is discounted, a demand bill or inland bill of exchange is purchased by the bank. To avoid any time factor, a demand bill is payable just on presentation before the drawee. As such, it is purchased outright by the banker and sold by the holder. In both the cases, the banker makes a small charge which in purchase of the bill is simply for the expense and trouble incurred in realizing it. In discounting, however, the charge includes

(i) interest for the unexpired period of the bill till the banker is required to retain it with himself, and (ii) compensation for the expense and trouble in realization.

20.2 BILL OF EXCHANGE

The term 'bill of exchange' may be defined as an order, in writing, requiring a certain person to pay a certain sum of money to a specified person. The legal definition of the term is given in Section 5 of the Negotiable Instruments Act which, reads as under:

"A bill of exchange is 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."

In other words, a bill of exchange is a written and signed order directing a person to pay a certain sum of money to the bearer of the instrument or to a specified person or his order.

Parties to a Bill of Exchange

Drawer: It is a person who makes a bill of exchange. In other words, he is the maker of bill of exchange.

Drawee: It is a person who is ordered (i.e. directed) to pay the amount of the bill of exchange i.e. on whom the bill of exchange is drawn. When the drawee accepts the bill of exchange (i.e. when he gives his consent to make the payment of the bill on due date), he is called the 'acceptor'.

Payee: It is a person to whom the amount of bill of exchange is payable.

Essentials of a valid bill of exchange

- ★ It must be in writing.
- ★ It must contain an express order to pay.
- ★ The order to pay must be unconditional.
- ★ It must contain an order to pay in terms of money only.
- ★ It must contain an order to pay a definite (i.e. certain) amount of money.
- ★ It must contain certain parities.
- ★ It must be signed by the drawer.

Important Kinds of Bills of Exchange

1. Accommodation Bill

It is a bill of exchange which is made only to provide financial help to some party. An accommodation bill is drawn, accepted or indorsed, without any consideration, by some person with a view to lend the credit of his name on the bill so that the person taking the bill can get the money for the same. The person who signs (i.e. accepts) the bill without any consideration, in order to accommodate some other person, is known as 'accommodating party' (or accommodation party), and the person who has been accommodated, is known as 'accommodated party'.

Since an accommodation bill is drawn for the benefit of the 'accommodated party', there is an implied agreement between the "accommodating party' and 'accommodated party' that either:

a. The accommodated party will himself pay the bill on maturity.

b. The accommodated party will provide funds to the accommodating party to make the payment of the bill on maturity.

c. The accommodated party will indemnify the accommodating party for any payment which the accommodating party might make in respect of the bill.

2. Fictitious Bill

It is a bill of exchange in which the name of the drawer, or a payee or both is fictitious. The term 'fictitious person' means (a) a person who is not in existence or (b) a pretended person i.e. a person who is in existence but never intended by the parties to be the drawer or payee of the bill of exchange. It may be noted that when a fictitious bill is accepted by the drawee, then the holder in due course of the bill can recover the amount due on it from such a drawee if he can prove that the signature of the supposed drawer and that of the first indorser are in same handwriting.

3. Documentary Bill and Clean Bill

Sometimes, a seller of goods draws a bill of exchange on the buyer for the price of the good, and the documents of title to the goods such as bill of lading, railways receipt, warehouses receipt etc., and some other documents such as invoice, shipping papers, marine insurance policy etc. are attached to the bill. In such cases, the bill of exchange is called a documentary bill. Such documents are delivered to the buyer only on the acceptance or payment of the bill. On the other hand, when no documents of title etc. are attached to a bill of exchange it is called a clean bill.

4. Bill in Sets

A bill of exchange drawn in parts is known as a bill in sets. Sometimes, the drawer and the payee of a bill of exchange are at distant places or in different countries. In such cases, the bill of exchange, which is sent from one place to another may be lost or miscarried in transit. This causes a lot of inconvenience and delay to the person to whom the bill is sent. In order to avoid such delay and inconvenience, and to ensure the safe transmission of at least one part of the bill, it is drawn in parts (generally three). These parts together constitute Bill in Sets. Each part is sent by a separate post, and if one or two parts are lost in transit, the payee can present the part which he has for acceptance or payment as the case may be. It may be noted that generally foreign bills are drawn in sets. Inland bills are rarely drawn in sets. Following are the rules regarding the bill in sets:

- ★ In case of a bill drawn in parts, all the parts together make a set and the whole set constitutes one bill only.
- ★ Each part of a bill in set must be numbered and contain a reference to other parts. If any one part of the set does not contain reference of other parts, then it shall become a separate bill if it falls in the hands of a holder in due course.
- ★ Each part must contain a provision that it shall continue to be payable so long as the other parts remain unpaid. When payment is made on

one of the parts, the entire bill comes to an end i.e. it is considered to be paid.

★ The drawer must sign all the parts of a set and deliver them to the payee. However, the stamp is affixed on one part only.

★ The drawee's acceptance is required only on one part. If an acceptor gives his acceptance on more than one part and they fall in the hands of different holders in due course, then the acceptor shall be liable on every such part as if it were a separate Bill.

★ When a person indorses different parts of the bill in favor of different persons, he will be liable on each such part as if it was a separate bill. In such a case the subsequent endorsers also become liable on each part.

★ Where different parts of a set are held by different holders in due course, he who first gets title to his part is entitled to all the other parts and can claim the money represented by the bill.

20.3 DISCOUNTING OF BILLS OF EXCHANGE

The most important form, in which bankers give accommodation without any collateral security, is the discounting of clean bills. This form of employment of a substantial part of the bankers' funds is still very popular, particularly with the commercial banks. The scheduled banks in India had at the end of 1952 inland Usance bills amounting to Rs.60.77 lakhs representing nearly 6.75 per cent of their deposits. As on the last Friday of March 1987, the Scheduled Banks in India had: Inland bills purchased amounting to Rs.1, 879 crores, Inland bills discounted Rs.1, 817 cores, Foreign bills purchased Rs. 1,059 crores and Foreign bills discounted Rs.484 crores. The total of these represents nearly 5% of the aggregate deposits of Rs.1,05,044 crores of these banks as on that Friday.

It will be clear from the figures given above that in India, banks do not hold bills to any large extent though there has been some improvement in the direction in recent years. This is due to the fact that in India, banks need not have liquid resources quite to the same extent as their counterparts in other countries.

20.4 REASONS FOR RESTRICTED USE OF BILLS IN INDIA

20.4.1 The System of Cash Credits and Running Accounts

The system of running accounts and cash credits is an important factor responsible for the restricted use of bills in India. In the case of cash credits, interest is paid only to the extent that credits are used and the bank can withdraw credits in the event of any deterioration in the positions of the borrowing party. In India, a merchant who buys goods on credit does not like to give his acceptances in exchange. He prefers to have a running account.

20.4.2 Lack of Facilities for Rediscounting

Before the Reserve Bank of India was started the Indian Joint-stock banks, in case of need, had to resort to the then Imperial Bank of India for financial assistance and as the latter competed with the former in commercial banking business, the joint stock banks preferred to make use of their Government securities portfolio for loans from the then central banking institution instead of getting their bills rediscounted by it so as to avoid disclosing the names of their clients whose bills they had discounted. Moreover, this facility of rediscounting was restricted to approved bills, i.e., bills approved by the then Imperial Bank of India, which, to make matters worse, offered no guidance to the other banks to what constituted an approved bill. Consequently, a banker discounting bills could not be sure as to the nature of the bills discounted by him that would be acceptable to the Imperial Bank of India for rediscounting. With the establishment of the Reserve Bank of India in 1934 facilities for rediscounting have been extended, under Section 17 of the Reserve Bank of India Act, 1934, to the scheduled banks in respect of bills arising out of bona fide commercial transactions and maturing within ninety days.

20.4.3 High Rate of Stamp Duty

The usance bills in India attract *ad valorem* stamp duty which adds to the cost of borrowing over and above the interest or discount. Although, the stamp duty was lowered recently its incidence is yet considerable.

20.4.4 Absence of Adequate Public Warehouses

The inadequacy of public warehouses and godowns for stocking produce constitutes a serious handicap in the way of the popularity of documentary bills with banks. As a matter of fact warehousing is a recent development in India and formerly, except a few bounded warehouses, there were practically no public warehouses. The warehouses recently established by the Central Warehousing Corporation and various State Warehousing Corporations are small in number for the storage requirements of the country and their receipts have a limited transferability.

20.4.5 Small Number of Bank Offices

The absence of a sufficient number of banking offices in the country also accounted for the lack of popularity of the Bills of Exchange. For instance, if goods are sent from Bombay to up-country place with no banking facilities the charges for the collections of bills drawn in connection with such consignments entail a heavy burden with the result that the parties wanting to remit money have to make use of the insurance facilities provided by the postal department. Moreover, this factor also stands in the way of ascertaining the credit position of parties in comparatively small places.

20.4.6 No Homogeneity of Customs Governing Hundies

The lack of uniformity in the customs governing the hundies, is another reason for the relative unpopularity of commercial bills in India. If the hundies were drawn in a simple language, without the long prefatory situations and unnecessary greetings and with their essential features definitely defined, they would circulate more freely than they do at present.

20.5 ADVANTAGES OF DISCOUNTING OF BILLS BY BANKS

The following are the chief points in favour of the employment of funds by commercial banks, in the discounting of bills:

(a) Certainty of Payment on Due Date: It is almost certain that the money invested in first class bills is realized on the due date, firstly, because a businessman who has accepted a bill endeavors to honor it, as otherwise his credit suffers; secondly, because, in case the acceptor fails to make the payment on the maturity of a bill, the banker will get his money from his customer, the drawer, or one of the endorsers more particularly the customer for whom he discounted the bill. Thus from the point of view of security, as well as, certainty of payment on the due date, the bills are considered so good, that the late Mr. George Ray, the author of "The Country Banker", considered them the best form of banking security.

(b) Employment of Funds for a Definite Period: The banker is able to employ his funds for a definite period and by judicious selections of the maturities of the bills he can so arrange the investment of his funds, as well enable him to meet all the foreseen demands on him, without keeping his funds idle for any time. For instance, if a banker receives a deposit of Rs.1,00,000/- for three months he can use the amount in discounting bills which will mature just a day or two before the deposit falls due.

(c) Liquidity: These bills constitute securities of a very liquid nature and when a banker finds it necessary to strengthen his cash reserve, he need not discount bills. In case of urgent or unforeseen demands, the banker can convert the bills held by him into cash, by having them rediscounted with the central banking institution of the country. Thus, a bank employing a very large part of its funds in bills can even do with a comparatively smaller reserve than another bank, whose bill portfolio is small.

(d) Freedom from Fluctuations in Prices: As compared with stock exchange securities, commercial bills have also the advantage of not being subjected to any appreciable fluctuations in prices. No doubt, with changes in monetary conditions or credit policies, fluctuations in the discount rate do take place and thus the rates at which a banker can get his commercial paper rediscounted may vary, but the variations are comparatively small and are of no material consequence even if the banker is compelled to convert his bills into cash.

(e) **Higher Yield:** The yield from the discounting of bills is slightly higher than that from loans or advances when the rates charged are equal, because, in the case of the former, the interest known as discount is deducted at the time of discounting the bills, whereas, in the latter case, it becomes payable only when the principal falls due or is payable quarterly, half-yearly or yearly.

(f) **New Accounts:** Parties who have to make payments of bills generally open accounts with banks holding bills drawn upon them. In this way bank, discounting bills are able to attract more customers.

20.6 PRECAUTIONS IN DISCOUNTING BILLS

1. **Bills must have drawn against commercial transaction:** In the first place the banker should see that the bills he discounts, are genuine commercial bills and not in the nature of accommodation paper, as the former have the advantage of being backed up by goods while the latter, is without any real backing. For example, when a cloth merchant in Calcutta buys a few bales of dhotis from Bombay merchant, and being unable to pay cash for this purchase, accepts a bill drawn upon him by the Bombay Merchant, he hopes to sell the goods and meet his acceptance with their sale proceeds. Thus, the bill is backed up by actual goods-dhotis. On the other hand, if the bill discounted is a "kite" or accommodation paper, which is merely a means between the drawer and the acceptor of raising money, it will not have such goods as a backing. The proceeds of such a bill may be utilized, but either in the payment of certain expenses or antecedent debts. Although, it may appear to be difficult to distinguish between the bills of one class from those of the other, a banker generally does not experience much difficulty in differentiating between the genuine bills and the accommodation papers. The question which the banker has to put to himself, is, whether or not, the bill is likely to have been issued as the result of some genuine commercial transaction between the drawer and the acceptor. It should also be remembered that Bills, given in payment of fixed assets such as buildings or machinery should be avoided, as such bills cannot be regarded as liquid.

2. **Documentary Bills or other Bills:** Secondly, the question, whether a banker should buy commercial paper bearing certain names, depends not only upon the credit of the parties, but also upon the class to which the bills belong. For instance, the banker need not make thorough inquiries about the credit of the parties in case of documentary bills to which documents of title to goods, such as bills of lading, railway receipt, insurance policies or invoices are attached, particularly when the goods concerned are necessaries of life. In case of dishonor of such a bill by the drawee, or in the event of any difficulty arising in connection with the realization of the amount from the drawer, the goods can be sold and the chances of loss to the banker minimized. However,

it must be remembered that such bills should not be purchased from parties whom the banker does not know well as there are certain risks attached to the business.

3. Credit of the Parties: Thirdly, the banker has to satisfy himself regarding the credit of the drawer, acceptor and endorsers. We have already stated how the credit department of a good modern bank collects and keeps handy, fairly detailed information regarding the credit of the different merchants whose names are likely to appear on commercial bills. If the various parties to the bill are the customers of the bank, fairly reliable information can be gathered from its own records.

4. Bill Complete and Free from Defects: Fourthly, the banker should see that the bill is complete in every respect. Not only must its form comply with the requirements of law, but also the bills must not be overdue or defective in any other respect. In case the banker comes to know of a defect in the title of his customer to the bill, he should refuse to discount it, as then the banker cannot be treated as a holder in due course and consequently his title to the bill will be rendered defective.

5. Penalty for Failure to Pay Stamp Duty: Fifthly, the bill must be duly stamped and conform to the provisions of the Indian Stamp act, 1889.

6. Customer's Account Credited: When a banker decides to discount a bill, he will proceed to credit his customer's current or overdraft account with the amount of the bill, less discounts charged. The bill is then entered in the Bills Receivable Book, and its date of maturity noted in the Bills Receivable Dairy.

20.7 LIABILITIES OF THE PARTIES

The drawee of a bill, after he has accepted it, becomes the principal debtor, but till then, the holder of a bill has no claim against him and he should look to the drawer and the endorsee for the payment of the same, in case the drawee refuses to accept it. The drawer by drawing the bill, undertakes that, on its presentment, it shall be duly accepted and paid according to its tenor. He also promises that, in case of its dishonor, he will compensate the holder, or any endorser, who is compelled to pay it, provided the necessary proceedings on its dishonor are duly taken. The endorser, by endorsing the bill, attests that the bill was complete when it left his hands. The liability of the endorsers stands in the order in which their names appear on the bill. The first endorser is liable to the second subsequent endorsers, the second to the third and the subsequent endorsers, and so on.

20.8 DISHONOR OF BILLS

On the dishonor of a bill discounted by the bank, the amount of the bill plus charges in connection with the dishonor should be debited to the customer's account, provided his credit balance, or the overdraft limit, is not exceeded. In such a case the bill should be returned to the customer, together with the advice about the debit, and no separate notice of dishonor is necessary. However, if the customer's balance or overdraft limit is not sufficient to cover the amount, the bill should be debited to overdue bills account so as to avoid loss of recourse to other parties on the bill; notice of dishonor should be sent to the customer, who should be requested to pay the amount due.

Rule governing the sending of Notice of Dishonor

When the person giving notice and the one to receive it reside in the same town, the notice must be sent to reach the other party on the day after the dishonor; when they reside in two different places the notice must be dispatched at the latest on the working day after the day of the dishonor. It must be remembered that the holder of a bill loses his right to claim the amount from the previous endorsers if he fails to inform them without undue delay of the fact of dishonor and all other parties against whom he wished to press his claim. This duty on the part of a banker is sometimes neglected with the result that he losses his right against endorsers. Such negligence results particularly in cases of documentary bills. The drawee may request the bank's agent to give him some time to pay the bill on the plea that the banker is protected by the goods. It is, however, to be remembered that the fact whether a bill is documentary or not is of no consequence so far as the duty of the banker to give notice is concerned. The need for precaution is greater in case one banker gives bills received from his customer to another banker for collection or sells bills to that banker.

20.9 BILL MARKET SCHEME

Early in 1952, the Reserve Bank of India took steps for the creation of a market in India and introduced on 16th January of the same year what is known as the Bill Market Scheme. Broadly, the scheme followed the system that prevailed prior to the establishment of the Reserve Bank of India under which the then Imperial Bank of India could borrow, during the busy season, funds from the Currency Department against internal bills or hundies drawn for financing bona fide trade or by the conversion of advances granted for the same purpose into usance bills. Under the Scheme, which was intended mainly to relieve seasonal stringency of banks against the security of usance promissory notes executed by their constituents in respect of cash credits, overdrafts and loans etc., into usance promissory notes maturing within 90 days and lodged them as security for the advances obtained from the Reserve Bank of India. It was

open to the borrowing bank to withdraw any of the bills lodged and to replace them by other bills. The Scheme, on the whole, enabled banks to obtain refinance from the Reserve Bank of India against their assets representing cash credit advances, whenever the lending bank wanted liquid funds urgently and was therefore very popular with the banks.

In 1958, the Reserve Bank of India extended the Bill Market Scheme to export bills to enable the Banks to extend credit facilities to exporters on a more liberal basis. The banks, however, could not avail themselves of these facilities because exporters were reluctant to draw usance bills as required by the Reserve Bank of India. The Reserve Bank of India therefore, introduced in March 1963 a new Export Bills Credit Scheme under which advances could be made by the Reserve Bank of India to schedule banks against their promissory notes repayable on demand and upon their declaration of holdings of eligible usance export bills drawn in foreign currencies or Indian Rupees and purchased or negotiated by them. This Scheme widened the range of collateral against which scheduled banks could borrow from the Reserve Bank of India and also slightly lowered the cost of borrowing as these promissory notes were not subject to stamp duty payable on usance promissory notes under the Bill Market Scheme.

Some the important factors which have been impending the growth of bill market in India is the predominance of the cash credit system of lending by banks, high stamp duty on bills, absence of adequate warehousing facilities for storing agricultural produce etc. Even in foreign countries, commercial bills have declined in importance. However, the Reserve Bank of India has always been eager to develop a bill market in the country. Some of the difficulties which have impeded the growth of a Bill Market in India, especially in the matter of provision of warehousing facilities, are being overcome as a result of Government initiative.

The term "bill marker" properly speaking comprises the following markets:

★ Treasury bills issued by the Central Government maturing at various periods, generally for 91 days.

★ Bank bills, being the bills of exchange accepted by a commercial bank or an accepting house which thereby become "eligible" paper for rediscount with the central Bank.

★ Ordinary trade bills purchased or discounted for customers. Whenever a seller of goods or creditor draws a bill on the buyer of goods or debtor, he has two alternatives. He can (a) either send the bill for collection through a bank, or (b) get it purchased or discounted with a bank.

New Bill Market Scheme of Reserve Bank or Bills Re-discounting Scheme 1970

The Reserve Bank of India in February 1970, constituted a Study Group to go into questions relating to enlarging the use of the bill of exchange as an instrument for providing credit and the creation of a bill market in India. The group which submitted its report in June 1970 comes to the unanimous conclusion that it would be advantageous to take steps to enlarge the use of the bill of exchange as an instrument of credit and to create a bill market in the country where bills could be purchased or sold according to the requirements of the institutions concerned. In the light of the recommendations of the Study Group, the Reserve Bank of India decided to introduce a Scheme Rediscounting Bills of Exchange with effect from 1st November 1970. The Scheme will cover genuine trade bills, i.e., those that evidence sale and/or dispatch of goods only. Bills of Exchange arising out of sale of commodities covered by the Reserve Bank of India's selective credit control directives issued from time to time will not be covered. Accommodation bills will not, of course, fall within the purview of the Scheme. A bill of exchange to be eligible under the Scheme for rediscount should be one: (a) drawn on and accepted by the purchaser's bank, or (b) drawn on the buyer and the buyer's bank jointly and accepted by them jointly, or (c) drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank (which has opened the letter of credit) to the effect that the bill was drawn for supply of goods and that the terms and conditions of the letter of credit have been duly complied with by the seller, or (d) drawn on and accepted by the buyer and endorsed by the seller in favor of his bank and bearing a legend by a licensed scheduled bank (who should be an endorser of the bill) to the effect that the bill will be paid by the said licensed bank on maturity. In all cases, however, the Reserve Bank of India will discount only such bills as are offered by a licensed scheduled bank. In order to avoid rediscounting of a number of small bills, it was originally laid down under the Scheme that the bills offered for discount should be in bunches and that the value of each bunch should not be less than Rs.50,000/- the limit was altogether abolished in November 1971, but for administrative convenience banks have been advised by Reserve Bank of India not to avail themselves of rediscounting facilities against bills of less than Rs.1,000 each as far as possible.

Having regard to the introduction of the new bill rediscounting Scheme under which refinance facilities would be available to banks at the bank rate round the year, and the availability of refinance from the Reserve Bank of India and other apex term-lending institution Industrial Development Bank of India under their schemes of refinance, the Reserve Bank of India in November 1971, discontinued the old Bill Market Scheme under which refinance was being

made available to banks against the security of Bills. However, the facilities under the old scheme are being made available for the specific purpose of providing refinance for food procurement operations and in specific cases for limited amounts where the need for refinance is genuine, but banks, especially smaller banks, are unable to provide a portfolio of eligible paper except through creating bills as under the old Bill Market Scheme.

Even then the New Bill Market Scheme did not become very popular until the busy season of 1973-74. The maximum refinance obtained by banks under the scheme in the busy season of 1972-73 was Rs.35.40 crores as on the 30th March, 1973. Considering the need to popularize the scheme on account of the various advantages of the bills finance, the Reserve Bank of India, while announcing the credit policy for the busy season of 1973-74, declared that 100% refinance would be available to banks for bills discounted by them under the New Bill Market Scheme. As the busy season of 1973-74 was market by severe credit stringency, the banks put a stop to all fresh credit limits and increases in existing limits. In some cases, limits were even frozen at the level up to which they were drawn. However, as 100% refinance was available to banks against bills purchased under New Bill Market Scheme, credit was still available to borrowers against bills. There was, therefore, a scramble for borrowing against bills under the scheme with the result that the amount of refinance availed of by banks against bills reached a record figure of Rs.278.71 crores in the month of April, 1974.

While, thus, the measures taken by the Reserve Bank of India gave a boost to the Scheme, the large amount of credit disbursed by banks against bills had the effect of partly nullifying the effects. The Reserve Bank of India, therefore, informed the banks that while they may encourage parties to avail themselves of credit limits against bills, the Reserve Bank of India refinance to banks against the bills was restricted to about 40% of their drawing under the Scheme. Over the years the availing of funds under the Bills Rediscounting Scheme has been gradually restricted and at present this facility is operated by the Reserve Bank of India on a discretionary basis, subject to the terms and conditions stipulated by it. It is to be seen as to what extent banks are able to encourage their customers to draw against the bills after the curtailment of refinance facilities by the Reserve Bank of India.

Check your progress - I

State whether True or False:

1. There is no stamp duty affixable on usance bills.
2. A document of title to goods is a consigner's copy, evidencing transport of goods to the drawee of a bill.
3. Clean bill is bill of exchange payable on demand.

4. Noting and protest is necessary when bills are returned by the drawee.
5. Advance against documentary bill is a short term lending.
6. Kite flying is drawn to accommodate the financial needs of another person

Let us sum up

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 is known as Bills of Exchange. A bill of exchange can be demand bill, which is payable on demand, and usance bill, payable after a certain period of time. An accommodation bill can also be drawn to accommodate the financial needs of another person. This is known as "Kite Flying". When a bill of exchange is accompanied by a document of title to goods, it is documentary bill. Clean bill is a bill of exchange, which is not accompanied by any of the document of title to goods. When a banker advances against a demand bill, it is referred to as bills purchased. Where an advance is granted against usance bill, it is called bills discounted.

Bankers will have to be careful against financing accommodation bills. Before sanctioning of bills to a customer, it is necessary that a credit report on the drawer and the drawee are ascertained by the banker. If the drawer and the drawee of the bills must be dealing in the same goods, for which the bills are drawn. The bills of exchange should be properly drawn and validly stamped. The bills should not be drawn in one centre and goods consigned in another centre. When the bill is not paid on the due date, the bill should be recalled from the drawee and the amount should be got reimbursed by debiting the drawer's account. If there is no sufficient balance or drawing power available, the bill along with the banker's charges should be debited to a separate account called Bills Returned Unpaid Account.

Advance against bills is self liquidating and it gets adjusted automatically on payment of the bill. Advance against documentary bill is a secured one. Further, as a holder for value, the banker is in a position to proceed against the acceptor and the drawer in case of dishonour. Bills advanced is short term lending. In discounting bills, the interest is recovered in advance, therefore a better yield to the banker compared to other forms of credit.

Glossary

Bill of exchange : 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.

Clean bill : A clean bill is a bill of exchange not accompanied by any of the document of title to goods.

Documentary bill : A bill of exchange accompanied by a document of title to goods is called documentary bill.

Accommodation bill : A bill of exchange drawn to accommodate another person, is known as accommodation bills.

Answers to check your progress

1. False 2. False 3. False 4. False 5. True 6. True

Model Questions

1. Define a bill of exchange and explain the various types.
2. What are the precautions to be taken by the banker while discounting a bill?
3. Enumerate the advantage of bill discounting.
4. Describe the bill market in India today.

TAMILNADU OPEN UNIVERSITY

B.COM., Second Year (BCO - 22)

Banking Theory, Law and Practice

Model Question Paper

Time: 3 Hrs | Max Marks: 75

Part - A

Answer any THREE (3 x 5 = 15)

1. Discuss the general utility services normally rendered by commercial banks in India.
2. Distinguish between 'Unit Banking' and 'Branch Banking'.
3. Write a short note on holder in due course.
4. Explain the role of Reserve Bank of India as banker's bank.
5. Explain the difference between bankers lien and pledge.

Part - B

Answer any FOUR (4 x 15 = 60)

6. What are the precautions a Banker must take while lending loans against.
   a) Stock exchange securities
   b) Land and building as securities
   c) Fixed deposit receipts as securities
7. Discuss the relationship between the banker and customer.
8. What precautions would you suggest a Banker must take while opening and operating an account in the name of clubs or Associations, Executors and Married Women?
9. Who is a collecting banker? What are his duties? What is the statutory protection given to a collecting banker.
10. How does commercial banks create credit?
11. Describe the role and performance of Reserve Bank of India.
12. "Entries made in the Pass Book by the Banker Constitute an Unquestionable record of transactions between the banker and the customer" Do you agree? give reasons.

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